TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1929

No. 323

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

KANSAS CITY STRUCTURAL STEEL COMPANY

No. 324

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

KANSAS CITY STRUCTURAL STEEL COMPANY

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

PETITION FOR CERTIORARI FILED AUGUST 14, 1929
CERTIORARI GRANTED OCTOBER 21, 1929

(34454)
(34455)

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A [Caption omitted].

1 Before U. S. Board of Tax Appeals

Docket 6232

KANSAS CITY STRUCTURAL STEEL COMPANY, Kansas City, Mo., petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE, respondent

For taxpayer: Phil D. Morelock, Esq., Armwell L. Cooper, Esq.
For the Commr.: O. Bennett, Esq.

Docket Entries

1925

Aug. 14. Petition received & filed.
" 17. Copy of petition served on solicitor.
" 17. Notification of receipt mailed taxpayer.
Sept. 5. Answer filed by solicitor.
" 11. Copy of answer served on taxpayer. Assigned 2-3-26.
Dec. 2. Motion that appeal be transferred to field calendar for hearing filed by taxpayer.
" 9. Order transferring to reserve calendar "C" for Kansas City Mo., hearing signed & filed. Both sides notified.

1927

July 22. Notice of hearing Oct. 19/27, Kansas City, Mo.
Oct. 19. Hearing had before Mr. Lansdon on merits. Stipulation of facts filed. Briefs due 12-18-27.
Nov. 29. Motion for an extension to 1-19-28 to file brief filed by taxpayer.
" 29. Granted to 1-19-28.

1928

Jan. 14. Brief filed by taxpayer.
April 30. Findings of fact & opinion rendered. Judgment will be entered for the respondent.
2 " 30. Order of redetermination entered.
Sept. 19. Supersedeas bond for $13,000 approved & ordered filed.
" 19. Petition for review by U. S. Cir. Ct. of Appeals, 8th Circuit, with assignments of error filed by taxpayer.
" 19. Præcipe filed by taxpayer.
" 19. Proof of service of petition & præcipe filed.
[Certificate to foregoing paper omitted in printing.]

Before United States Board of Tax Appeals

Kansas City Structural Steel Co., Kansas City, Missouri.

Petition of Kansas City Structural Steel Company for appeal

Filed Aug. 14, 1925

The above-named taxpayer hereby appeals from the determination of the Commissioner of Internal Revenue set forth in his deficiency letter (IT:E:SM–JWN–21475–A–19632) dated June 17, 1925, and as the basis of its appeal sets forth the following:

1. The taxpayer is a Missouri corporation with principal offices at Kansas City, Missouri.

2. The deficiency letter (copy of which is attached) was mailed to the taxpayer June 17, 1925, and states a deficiency of $38,277.86.

3. The taxes in controversy are income and profits taxes for the calendar year 1918 and are more than $10,000.00, to-wit, about $20,000.00.

4. The determination of tax contained in said deficiency letter is based upon the following errors:

In its letter of January 5, 1924 (IT:CR:A–RPH–App), copy of which is attached, the Income Tax Unit showed an increase in net income of $34,988.78 as follows:

3 Structural stores	Reported by taxpayer	Corrected	Increase
Inventory 12/31/18	$446,984.06	$612,833.52	$165,849.46
" 12/31/17	271,827.87	402,688.55	130,860.68
Net increase			34,988.78

In a letter dated November 13, 1924 (IT:CR:A–JML), copy of which is attached, the commissioner decreased the item of $34,988.78 by $16,758.69. This was a deficiency letter but was withdrawn by the commissioner in order that the profits tax of this corporation might be computed under the provision of section 210 of the revenue act of 1917 and section 328 of the revenue act of 1918 for the calendar year 1917 and 1918. The deficiency letter of June 17, 1925, denies the application of the relief section for 1918. The taxpayer does not appeal from the decision of the commissioner with respect to the application of section 328 of the revenue act of 1918, but this appeal is based on statutory grounds in that the commissioner erred as follows:

(a) Increasing the inventory of the taxpayer as at December 31, 1917, by $130,860.68, and

(b) Increasing the inventory of the taxpayer as at December 31, 1918, by $148,090.78.

(c) Failure to recognize the fact that the taxpayer maintained an equivalent inventory of 5,554 tons of structural steel set aside and maintained which should have been priced at the original cost, to wit, $2.136 per cwt. f. o. b. Kansas City.

(d) The commissioner valued the entire inventory, including the equivalent inventory on a basis higher than cost.

(e) Failure of the commissioner to allow a loss in inventory as at December 31, 1918, due to the decline in March of 1919 of steel prices.

5. The facts upon which the taxpayer relies as the basis of its appeal are as follows:

(a) At the close of 1916 the corporation had on hand 5,554 tons of structural steel, which is set aside and maintained as an equivalent inventory and continuously kept it as such. In emergencies when material had been ordered from the mills and could not be delivered in time for use, steel was borrowed from the equivalent inventory and reimbursed upon arrival of mill deliveries. These 5,554 tons were inventoried at cost, to wit, $2.136 per cwt. f. o. b. Kansas City.

The corporation fabricates material for specific contracts and
4 carries no finished products in stock. So far as practical material is ordered and procured from the mills for specific structures or contracts. This rule and practice is fixed and determined. The equivalent inventory is kept on hand for emergency purposes and is not for sale, constituting a reservoir and not a merchandising stock. The commissioner has priced this equivalent inventory or reservoir, constituting one of the fixed assets of the corporation, at current prices. This equivalent inventory has been maintained as any other fixed asset owned and used by the company. It was not for sale, permanent in kind, quality, character, and quantity.

(b) In March, 1919 (between the 20th and 27th), prices were reduced from that which prevailed when the inventory was priced December 31, 1918, as follows:

Tank plates	$3.24 per cwt. f. o. b. Kansas City.
Steel bars	2.94 per cwt. f. o. b. Kansas City.
Structural shapes	3.04 per cwt. f. o. b. Kansas City.

During the first three and one-half months of 1919 the company sold and withdrew from stock:

January	1,507,930 pounds,
February	1,545,411 pounds,
March, ½	738,413 pounds,
	3,791,754 pounds of steel,

leaving an equivalent balance of the original, December 31, 1918, of 7,982,743 pounds. No physical inventory was taken in March, so that in figuring the following reduction, representing loss in inventory as at December 31, 1918, we proportion the same pro rata to the quantities in each class December 31, 1918.

Balance 3/15/19, 7,982,743 lbs., @ 3.4544		$275,755.84
Tank plates, 4,375,763 lbs., @ 3.24	$141,744.72	
Steel bars, 565,222 lbs., @ 2.94	16,617.53	
Structural shapes, 2,914,294 lbs., @ 3.04	88,594.54	
Scrap iron, 127,464 lbs., @ 1.00	1,274.64	
		248,261.43
Loss in inventory sustained		27,494.41

6. The taxpayer in support of its appeal relies upon the following propositions of law:

5 (a) The equivalent inventory of 5,554 tons on hand as at December 31, 1916, and maintained as a fixed reservoir should be priced at actual cost at each inventory period. No profit can arise from such an equivalent inventory because it was maintained as a fixed quantity and was not stock in trade but a permanent asset.

(b) Section 214 (12) (a), revenue act of 1918.

Wherefore the taxpayer respectfully prays that this board may hear and determine its appeal.

PHIL D. MORELOCK,
Attorney for Taxpayer,
710 Land Bank Building, Kansas City, Mo.

[*Duly sworn to by Fred H. Fitch; jurat omitted in printing.*]

Form NP-2.

TREASURY DEPARTMENT,
Washington, June 17, 1925.

IT:E:SM-JWN-21475-A-19632.

KANSAS CITY STRUCTURAL STEEL CO.,
1012 Baltimore Avenue, Kansas City, Mo.

SIRS: An audit of your income and excess-profits tax return for the calendar year 1917 and your income and profits-tax re-

6 turn for the calendar year 1918 has resulted in the determination of an overassessment for the year 1917 amounting to $23,428.45 and a deficiency in tax for 1918 of $38,277.86, as shown in the attached statement.

In accordance with the provisions of section 274 of the revenue act of 1924 you are allowed 60 days from the date of mailing of this letter within which to file an appeal to the United States Board of Tax Appeals contesting in whole or in part the correctness of this determination.

Where a taxpayer has been given an opportunity to appeal to the United States Board of Tax Appeals and has not done so within the 60 days prescribed and an assessment has not been made, or where a taxpayer has appealed and an assessment in accordance with the final decision on such appeal has been made, no claim in abatement in respect of any part of the deficiency will be entertained.

If you acquiesce in this determination and do not desire to file an appeal, you are requested to sign the inclosed agreement consent-

ing to the assessment of the deficiency and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:E:SM-JWN-19740. In the event that you acquiesce in a part of the determination, the agreement should be executed with respect to the items agreed to.

Respectfully,

D. H. BLAIR, *Commissioner*,
By J. G. BRIGHT, *Deputy Commissioner*.

Inclosures: Statements; agreement, Form A.

STATEMENT

IT:E:SM-JWN-21475-A-19632.

In re Kansas City Structural Steel Co., 1012 Baltimore Avenue, Kansas City, Missouri.

Years—	Deficiency in tax	Overassessment
1917	----------	$23,428.45
1918	$38,277.86	----------

7 1927

Reference is made to your protest dated April 3, 1925, against the allowance of your application for assessment of your profits tax under the provision of section 210 of the revenue act of 1917, as set forth in bureau letter dated March 20, 1925.

After a careful review of your protest and of all the evidence submitted in support of your contentions, you are advised that the bureau holds that the comparatives used are representative concerns which meet all the requirements of section 210 of the revenue act of 1917 in the essential component parts and that the rate allowed is equitable. Accordingly the conclusions set forth in the above-mentioned letter are sustained.

Your case is therefore deemed closed.

1918

In bureau letter dated March 20, 1925, you were advised of the denial of your application for the assessment of your 1918 profits tax under the provisions of section 328 of the revenue act of 1918. This denial was based upon the fact that it was found that your profits tax as computed under the provisions of section 301 is not in excess of the average profits tax paid by a group of representative concerns which in the aggregate may be said to be engaged in a like or similar trade or business to that of your company.

Changes having been made in the computation of your 1917 tax liability, the following recomputation has been made for the year 1918.

Net income, as shown in bureau letter dated November 13, 1924		$226,018.60
Invested capital, as shown in the letter mentioned above		1,119,487.02
Add:		
1917 Federal income tax, as previously prorated	$135,064.60	
Corrected adjustment, $223,064.62 × 200/365	122,227.17	
		12,837.52
Invested capital as adjusted		1,132,324.54
Excess-profits credit (8% of invested capital plus $3,000.00)		93,585.96
8 War profits credit:		
Average net income for pre-war period		39,308.48
Plus 10% of increase in invested capital of the taxable year over the average for pre-war period		85,703.42
Exemption		3,000.00
Total		128,011.90
War and excess-profits tax		78,405.43
Net income	$226,018.60	
Less:		
War and excess-profits tax	$78,405.43	
Exemption	2,000.00	
	80,405.43	
Amount taxable at 12%	145,613.26	
Tax at 12%		17,473.59
Total tax assessable		95,879.02
Tax previously assessed, account #41874		57,601.16
Deficiency		38,277.86

In accordance with the above conclusions, your claim for the refund of $26,000.00, income and profits tax assessed for the year 1918, will be rejected in full. The collector of internal revenue for your district will be officially notified of the rejection.

The overassessment shown above will be made the subject of a certificate of overassessment which will reach you in due course through the office of the collector of internal revenue for your district and will be applied by that official in accordance with section 281 (a) of the revenue act of 1924.

The right of appeal, as indicated on the first page of this letter, refers only to any deficiency in tax shown herein, inasmuch as there is no provision in the revenue act of 1924 granting the right to appeal from the determination of any overassessment found upon an audit of your returns.

A copy of this communication has been forwarded to your authorized representatives, Shouse, Doolittle and Morelock, 15 W. 10th Street, Kansas City, Missouri.

Kansas City Structural Steel Company

Year ended December 31, 1918

SCHEDULE 5.—*Proof of Invested Capital*

Capital stock		$500,000.00
Surplus		715,931.45
Reserve for emergencies		55,490.12
Total, corrected balance sheet beginning of year		1,271,421.57
Reductions:		
Dividends	$15,869.86	
Federal taxes	135,064.69	
Inadmissibles	702.55	
Total (deduct from above)		151,637.10
As shown on Schedule 3		1,119,784.47

SCHEDULE 6.—*Computation of excess-profits and war-profits credits*

Consolidated net income, taxable year (Schedule 1)	$244,155.69
Average consolidated net income, pre-war period (Schedule 1 of return)	39,308.48
Consolidated invested capital, taxable year (Schedule 3)	1,119,784.47
Average consolidated invested capital, pre-war period (revenues agent's report)	275,290.32
Increase in invested capital for taxable year as compared with average for pre-war period	844,494.15
Excess-profits credit:	
8% of invested capital for taxable year	89,582.76
Exemption	3,000.00
Excess-profits credit	92,582.76
War-profits credit:	
Average net income for pre-war period	39,308.48
Plus 10% of increase in invested capital as compared with average for pre-war period	84,449.42
Total	123,757.90
Exemption	3,000.00
War-profits credit	126,757.90

SCHEDULE 7

	Income	Tax
Excess-profits tax:		
Net income for taxable year	$244,155.69	
Less excess-profits credit	92,582.76	
Balance	151,572.93	
Taxable at 30%	131,374.13	$39,412.24
Taxable at 65%	20,198.80	13,129.22
	151,572.93	52,541.46
War-profits tax:		
Net income for taxable year	244,155.69	
Less war-profits credit	126,757.90	
Taxable at 80%	117,397.79	93,918.22
Less excess-profits tax		52,541.46
War-profits tax		41,376.77
Total excess-profits and war-profits tax		98,918.23

		Income	Tax
Income tax:			
Net income for taxable year		$244,155.69	
Less: War-profits and excess-profits tax	$93,918.23		
Exemption	2,000.00		
		95,918.23	
Taxable at 12%		148,237.46	$17,788.50
Total tax			111,706.73
Previously assessed			57,601.16
Additional tax to be assessed			54,105.57

TREASURY DEPARTMENT,
Washington, Nov. 13, 1924.

IT:CR:A–JML.

KANSAS CITY STRUCTURAL STEEL COMPANY,
1012 Baltimore Avenue, Kansas City, Missouri.

SIRS: An examination of your income-tax returns, books of account, and records for the year 1918, together with the information heretofore submitted, has been made, disclosing an additional tax liability of $39,181.61, and the results thereof are outlined in attached statement and schedules.

Waiver for 1918 is on file in this office.

In accordance with the provisions of section 274 of the revenue act of 1924, you are allowed 60 days from the date of this letter within which to file an appeal to the Board of Tax Appeals contesting in whole or in part the correctness of this determination.

Where a taxpayer has been given an opportunity to appeal
11 to the Board of Tax Appeals and has not done so within the 60 days prescribed and an assessment has been made, or where a taxpayer has appealed and an assessment in accordance with the final decision on such appeal has been made, no claim in abatement in respect of any part of the deficiency will be entertained.

If you acquiesce in this determination and do not desire to file an appeal, you are requested to sign the enclosed agreement consenting to the assessment of the deficiency and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:CR:A–JML. In event that you acquiesce in a part of the determination the agreement should be executed with respect to the items agreed to.

Respectfully,

D. H. BLAIR, *Commissioner,*
By O. BALLEN,
Deputy Commissioner.

Enclosures: Statements; agreements, Form A; Schedules 1 to 7, revised.

IT:CR:A–JML.

STATEMENT OF RETURNS

Examined and resulting tax liability:

Company—Kansas City Structural Steel Company.

Year 1918. Form 1120. Additional tax, $39,181.61.

Revenue agent's report dated October 23, 1920, bureau letter dated January 5, 1924, your brief dated January 30, 1924, and conference February 21, 1924, have been made the basis of adjustments which are fully explained in attached revised Schedules 1 to 71, inclusive.

All points of difference have been adjusted as agreed to by you in conference.

Relative to the loss on a part of the inventory as at December 31, 1918, based on value of the amount still on hand at March 15, 1919, the bureau holds that such loss is not allowable as a deduction under the provisions of section 214 (a) (12) of the revenue act of 1918 and article 265 of Regulation 45.

Waiver for 1918 has been filed.

12 Kansas City Structural Steel Company

Year ended December 31, 1918

REVISED SCHEDULE 1.—*Net income*

Net income as disclosed by bureau letter dated 1/5/24		$44,155.69
As corrected		226,018.68
Net deductions		18,137.01
Deductions:		
(a) Inventory	$16,758.68	
(b) Blacksmith furnace	1,030.58	
(c) Depreciation	347.75	
Total deductions, as above		18,137.01

REVISED SCHEDULE 2.—*Explanation of items changed*

(a) Inventory as at December 31, 1918, has been revised as shown in your brief and as agreed to in conference February 21, 1924, as follows:

Inventory as previously deducted		$612,833.52
" as corrected		596,074.84
Decrease		16,758.68

(b) This represents blacksmith furnace expensed in 1918 and allowed as a deduction in conference February 21, 1924.

(c) Depreciation on brick buildings has been revised as agreed upon in conference 2/21/24.

Cost beginning of year	$65,903.34	
" end " "	73,186.25	
Average	69,544.79	
69,544.79 at 2½%=		$1,738.62
Amount previously deducted		1,390.87
Additional deduction		347.75

REVISED SCHEDULE 3.—*Invested capital, 1918*

As shown in bureau letter dated 1/5/24	$1,119,784.47
As corrected	1,119,487.02
Net decrease, as explained below	297.45
Increases: (a) Inadmissibles	702.55
Decreases: (b) Missouri River Navigation stock	1,000.00
Net decrease, as above	297.45

13 REVISED SCHEDULE 4.—*Explanation of Items Changed*

(a) Since the inadmissible assets were restored in error as shown under (b) below, the amount deducted from invested capital on account of such inadmissible has been restored.

(b) Capital stock of the Missouri River Navigation Company added to invested capital in bureau letter dated January 5, 1924, has been deducted as agreed to in conference February 21, 1924.

REVISED SCHEDULE 5.—*Proof of invested capital*

Capital stock		$500,000.00
Surplus		714,931.45
Reserves		55,490.12
Total, corrected balance sheet beginning of year		1,270,421.57
Reductions: Dividends	$15,869.86	
Federal taxes, 1917	135,064.69	
Total (deduct from above)		150,934.55
As shown on Schedule 3		1,119,487.02

REVISED SCHEDULE 6.—*Computation of excess-profits and war-profit credits*

Net income, taxable year (Schedule 1)	$226,018.68
Average net income, pre-war period	39,308.48
Invested capital, taxable year (Schedule 3)	1,119,487.02
Average invested capital, pre-war period	275,290.32
Increase in invested capital for taxable year as compared with average for pre-war period	844,196.70
Excess-profits credit:	
8% of invested capital for taxable year	89,558.96
Exemption	3,000.00
Excess-profits credit	92,558.96
War-profits credit:	
Average net income for pre-war period	39,308.48
Plus 10% of increase in invested capital as compared with average for pre-war period	84,419.67
Total	123,728.15
Exemption	3,000.00
War-profits credit	126,728.15

14 REVISED SCHEDULE 7.—*Computation of total tax*

	Income	Tax
Excess-profits tax:		
Net income for taxable year	$226,018.68	
Less excess profits credit	92,558.96	
Balance	133,459.72	
Taxable at 30%	131,338.45	$39,401.54
Taxable at 65%	2,121.27	1,378.83
	133,459.72	40,780.37
War-profits tax:		
Net income for taxable year	226,018.68	
Less war-profits credit	126,728.15	
Taxable at 80%	99,290.53	79,432.42
Less excess-profits tax		40,780.37
War-profits tax		38,652.05
Total excess-profits and war-profits tax		79,432.42
Income tax:		
Net income for taxable year	226,018.68	
Less: War-profits and excess-profits tax	$79,432.42	
Exemption	2,000.00	81,432.42
Taxable at 12%	144,586.26	17,350.35
Total tax		96,782.77
Previously assessed		57,601.16
Additional tax to be assessed		39,181.61

TREASURY DEPARTMENT,
Washington, Jan. 5, 1924.

IT:CR:A–RJH–APP.

KANSAS CITY STRUCTURAL STEEL COMPANY,
1012 Baltimore Avenue, Kansas City, Missouri.

SIRS: An examination of your income-tax return for the year 1918, together with information heretofore submitted, has been made, and the results thereof are outlined in attached statement and schedules.

15 In accordance with the provisions of section 250 (d) of the revenue act of 1921 you are granted thirty days within which to file an appeal and to show cause or reason why this tax or deficiency should not be paid. The appeal, if filed, must be addressed to the Commissioner of Internal Revenue, Washington, D. C., for the specific attention of IT:CR:A–RJH–App.

Treasury Decision No. 3492, setting forth the privileges of taxpayers in cases of appeal, is attached for your information and guidance.

Where a taxpayer has been given an opportunity to appeal and has not done so, as set forth above, and an assessment has been made,

or where a taxpayer has appealed and an assessment in accordance with the final decision on such appeal has been made, no claim in abatement of the assessment will be entertained.

This assessment is in addition to all other outstanding and unpaid assessments appearing upon the collector's list.

Payment should not be made until a bill is received from the collector of internal revenue for your district, and remittance should then be made to him.

Respectfully,

J. G. BRIGHT,
Deputy Commissioner.

Inclosure: T. D. 3492; statement; Schedules 1 to 7, inclusive.

IT:CR:A-RJH-App.

STATEMENT OF RETURNS

Examined and resulting tax liability:

Company—Kansas City Structural Steel Co., 1012 Baltimore Avenue, Kansas City, Missouri.

Year 1918. Form 1120: Additional tax, $54,105.57.

Full detail of adjustments producing the above stated results are contained in attached Schedules 1 to 7, inclusive, revenue
16 agent's report dated October 23, 1920, committee on appeals and review recommendation No. 4747, and engineer's report dated October 9, 1920.

Kansas City Structural Steel Company

Year ended December 31, 1918

SCHEDULE 1.—*Net income*

Net income as disclosed by return		$177,178.87
As corrected		244,155.69
Net additions		66,976.82
Additions:		
(a) Emergency fund	$10,810.38	
(b) Inventories	34,988.78	
(c) Donations	1,056.00	
(d) Blacksmith furnace	1,030.58	
(e) Amortization	2,061.67	
(f) Depreciation	9,099.95	
(g) Emergency fund	8,134.21	
Total additions		67,181.57
Deductions:		
(h) Loss on farm		204.75
Net additions, as above		66,976.82

SCHEDULE 2.—*Explanation of items changed*

(a) Additions to emergency reserve are not allowed as a deduction from income as outlined in O. D. 964, C. B. #5, page 118.

(b) The net increase in income due to increase in inventories, amounting to $34,988.78, is explained as follows:

Structural stores	Reported by taxpayer	Corrected	Increase
Inventory, 12/31/18	$446,984.06	$612,833.52	$165,849.46
Inventory, 12/31/17	271,827.87	402,688.55	130,860.68
Net increase			34,988.78

(c) Additional donations were found by the revenue agent amounting to $1,056.00, as shown in report.

(d) This item is a capital item and is disallowed as a deduction from income in accordance with article 293, Regulations 45.

(e) Amortization is allowed here in the amount allowed on engineer's report dated October 9, 1920, and prorated as follows:

17	Allowed in 1918	$9,404.73	
	Allowed in 1919	1,706.58	$1,706.58
	Disallowed	355.09	355.09
		11,446.40	2,061.67

(f) Depreciation is disallowed, as shown by the following exhibit:

	Taken on return	Allowed on revenue agent's report
Buildings	$7,757.10	$3,268.84
Shop equipment	18,511.46	13,928.72
Furniture and fixtures	1,241.05	1,033.02
Heating system		179.08
Total	27,509.61	18,409.66

(g) This item was deducted from 1918 and is not an allowable deduction

(h) Loss on Greer County Farm, disallowed in 1917, is allowed here, as the actual loss was sustained in the year 1918.

SCHEDULE 3.—*Consolidated invested capital*

As reported on original return		$1,179,150.00
As corrected		1,119,784.47
Net decrease as explained below		59,365.53
Increases:		
(a) Buildings	$1,268.66	
(b) Shop Equipment	122.81	
(c) Greer County Farm	204.75	
(d) Erection equipment	9,497.52	
(e) Inventory adjustment	130,860.68	
(f) Furniture and fixtures	475.82	
(g) Missouri River Navigation stock	1,000.00	
(h) Heating equipment	2,558.24	
Total increase		145,988.48

Decreases:		
(i) Appreciation	$64,389.29	
(j) Reserve for depreciation	50,906.98	
(k) Federal taxes	73,485.33	
(l) Dividend	15,869.86	
(m) Inadmissibles	702.55	
Total decrease		$205,354.01
Net decrease, as above		59,365.53

18 SCHEDULE 4.—*Explanation of items changed*

(a) and (b) These items represent depreciation credited direct to asset account in 1910.

(c) The loss taken on the books in 1917 was not sustained until 1918, and accordingly this amount is restored to invested capital.

(d) The net book value of erection equipment was adjusted to the actual inventory submitted and results in an increase in 1917 income and 1918 invested capital.

(e) This adjustment was sustained by committee on appeals and review recommendation No. 4747.

(f) Depreciation set up in 1910 was credited direct to the asset account and is reversed here.

(g) In conference of November 10, 1922, this item was disallowed as a deduction from income in 1917 and is restored to surplus.

(h) Heating equipment expenses in 1917 is capitalized.

(i) Appreciation of land and buildings is eliminated from invested capital.

(j) Reserve for depreciation is increased by this amount and this action was sustained by the committee on appeals and review.

Increase in reserve for depreciation at 12/31/16	$56,412.66	
Excessive depreciation for 1917	5,505.68	
Net increase at 12/31/17		50,906.98

(k) Corrected income and excess-profits taxes for 1917 is prorated as follows:

246,493.97×200/365=	$135,064.50	
Prorated on return	61,579.36	
Net increase		73,485.33

(l) Dividends paid during the first sixty days of the year are deemed to have been paid from surplus, and are prorated from invested capital from date paid as follows:

19 $17,500.00×331/365= $15,869.86

(m) Inadmissible asset adjustment:

Average total assets	$1,595,352.24
Average inadmissible assets	1,000.00
Decimal	.000627
$1,120,487.02×.000627	702.55

Now, September 25, 1928, the foregoing petition certified from the record as a true copy.

B. D. GAMBLE,
Clerk, U. S. Board of Tax Appeals.

[Seal, U. S. Board of Tax Appeals, 1924.]

Before United States Board of Tax Appeals

Appeal of Kansas City Structural Steel Co., Kansas City, Missouri

Answer of Commissioner of Internal Revenue

Filed Sep. 5, 1925

The Commissioner of Internal Revenue, by his attorney, A. W. Gregg, Solicitor of Internal Revenue, for answer to the petition of the above-named taxpayer, admits, denies, and alleges as follows:

1. Admits the allegations contained in paragraphs 1, 2, and 3 of the petition.

2. Denies the allegation of error that the commissioner erroneously adjusted the inventories at the beginning and end of the taxable year 1918, as alleged in paragraph 4, subdivisions (a) to (d), inclusive.

3. Denies that any error was made in failing to allow the alleged loss in inventory as at December 31, 1918, as a deduction.

4. Denies all the material allegations of facts in paragraph 5 and subdivisions thereof in the petition.

5. Denies generally and specifically each and every allegation contained in the taxpayer's petition not hereinbefore admitted, qualified, or denied.

20 Propositions of law

1. Correct inventories in accordance with section 203 of the revenue act of 1918 have been used in determining the income for 1918.

2. The word "inventory" contained in section 203 of the revenue act of 1918 means the inventory as a whole.

3. The entire inventory of a taxpayer must be valued on the same basis.

4. A loss in inventory is deductible only under the provisions of section 234 (14).

Wherefore it is prayed that the petition be dismissed and the appeal denied.

A. W. GREGG,
Solicitor of Internal Revenue,
Attorney for Commissioner of Internal Revenue.

Of counsel:

BENJAMIN H. SAUNDERS,
Special Attorney, Bureau of Internal Revenue.

[Certificate to foregoing paper omitted in printing.]

Before U. S. Board of Tax Appeals

Docket Nos. 6232, 13554

KANSAS CITY STRUCTURAL STEEL COMPANY, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Filed Oct. 19, 1927

Stipulation of facts

It is hereby stipulated and agreed by and between the Commissioner of Internal Revenue and the Kansas City Structural Steel Company that the following statement of facts in the above appeal now pending before the United States Board of Tax Appeals is correct.

(a) Valuation of inventory

1. The Kansas City Structural Steel Company is a corporation organized and existing under the laws of the State of Missouri with its officers at Kansas City, Missouri.

21 2. The company duly rendered its tax returns to the collector of internal revenue for the sixth district of Missouri for the taxable periods under consideration.

3. The company is engaged in the fabrication and erection of structural steel plates for buildings, bridges, tanks, etc. It fabricates material for specific structures or contracts and carries no finished product in stock. Material is ordered and procured from the mills for each specific structure or contract, except that a supply of material, as shown in Exhibit A, has been kept on hand for emergency use (from which material is borrowed and replaced) to insure the prompt and orderly execution of contracts in view of delay, etc., incident to shipments from the mills and other exigencies affecting the availability for use when needed of material ordered for a particular job. When such material is used, it is charged to the contract at its replacement cost and is promptly replaced with material of a like kind and in a like quantity.

4. As at December 31, 1916, the company had on hand 5,554 tons of structural steel which it priced at $1.70 per hundredweight f. o. b. Pittsburgh, representing cost price. This price represented the highest normal market encountered since 1895. Beginning with 1916 the price of structural steel advanced suddenly until it reached $4.50 per hundredweight f. o. b. Pittsburgh for structural shapes and $9.45 per hundredweight f. o. b. Pittsburgh for tank plates. On September 24, 1917, the Government fixed the price of steel f. o. b. Pittsburgh as follows:

Structural shapes	$3.00 per hundredweight.
Tank plates	3.25 " "

Upon the relinquishment of Government control and subsequently prices per hundredweight f. o. b. Pittsburgh were as follows:

	1919	1920	1921
Structural shapes	$2.80	$2.45	$1.50
Tank plates	3.00	2.65	1.50

Refer to Exhibit B, extract from Iron Trade Review of January 1, 1925, page 100. See also Exhibit C.

5. The company, at the end of the years 1916, 1917, 1918, 1919, and 1920, valued its said supply of 5,554 tons at the cost price prevailing at the close of 1916, or $1.70 per hundredweight f. o. b. Pittsburgh. The total inventory as valued by the company and as valued by the commissioner, together with the difference, follows:

Date	Per company	Per commissioner	Increase
12/31/17	$271,827.87	$402,688.55	$130,860.68
12/31/18	446,984.06	612,833.52	165,849.46
12/31/19	449,976.69	562,992.28	113,015.59
12/31/20	319,189.26	436,302.87	117,113.61

As shown by Exhibit A, the total amount of petitioner's inventory dropped below the 5,554 tons during each year. However, it was replaced before the close of these years, except the years 1917 and 1921. The company had on hand at the stated dates the following amounts of steel in tons:

Date	Amount in tons	Date	Amount in tons
December 31, 1916	5,554	December 31, 1922	9,341
December 31, 1917	5,298	December 31, 1923	8,732
December 31, 1918	5,887	December 31, 1924	10,411
December 31, 1919	6,957	December 31, 1925	7,202
December 31, 1920	7,246	December 31, 1926	8,126
December 31, 1921	4,512		

All materials of like dimensions are piled piece upon piece in perpendicular piles. Materials for specific contracts is not included in above figures or shown on Exhibit A.

When the material on hand at the close of the year exceeded 5,554 tons, the excess was priced by petitioner at cost or market, whichever was lower. Beginning with December 31, 1921, and for subsequent years, after prices became normal, the entire inventory was priced by petitioner at cost or market, whichever was lower. The Commissioner of Internal Revenue in pricing the inventory of the company has disregarded the said fixed quantity of 5,554 tons, assuming that the last purchases represented the entire inventory and using said last purchases as a basis for valuation.

6. The following tons of steel were fabricated by the company yearly:

1916	27,999 tons.	1922	35,925 tons.
1917	28,319 "	1923	58,124 "
1918	20,266 "	1924	34,425 "
1919	31,432 "	1925	33,105 "
1920	40,827 "	1926	35,863 "
1921	27,040 "		

(b) Loss in inventory, 1919

In March, 1919 (between the 20th and 27th), prices were reduced from that which prevailed when the inventory was priced December 31, 1918, to the following:

Tank plates	$3.24 per cwt. f. o. b. Kansas City
Steel bars	2.94 " " " " " " "
Structural shapes	3.04 " " " " " " "

During the first three and one-half months of 1919 the company sold and withdrew from stock:

January	1,507,930 pounds.
February	1,545,411 pounds.
March, ½ of tonnage	738,413 pounds.
Total	3,791,754 pounds of steel.

There were on hand at December 31, 1918, 11,774,497 pounds of steel. After substracting therefrom the 3,791,754 pounds withdrawn from December 31, 1918, to March 16, 1918, there remained on hand March 15, 1919, 7,982,743 pounds of steel. No physical inventory was taken on March 15, 1919. In allocating the tonnage to the following classification the same proportion has been applied to the 7,982,743 tons which existed with respect to the inventory as at December 31, 1918:

Balance 3/15/19, 7,982,743 lbs., $3.4554		$275,755.81
Tank plates, 4,375,763 lbs., $3.24	$141,744.72	
Steel bars, 565,222 lbs., $2.94	16,617.53	
Structural shapes, 2,914,294 lbs., $3.04	88,594.54	
Scrap iron, 127,464 lbs., $1.00	1,274.64	248,261.43
Loss in inventory claimed by petitioner		27,494.41

The 3.4544 applied as a multiple in arriving at the value of the 7,982,743 pounds of steel on hand as at March 15, 1919, is the
24 average price of the composite inventory as at December 31, 1918, as established by the commissioner. The prices applied as multiples to the classes of material as at March 15, 1919, in computing the value of each class are taken from the Iron Trade Review plus 59 cents freight per cwt. to Kansas City.

No claim for abatement was filed under the provisions of section 214, paragraph 12 (a) of the revenue act of 1918.

ORRIS BENNETT,
Counsel for Respondent.
PHIL D. MORELOCK,
Counsel for Petitioner.

1912
1913
TONS
13000
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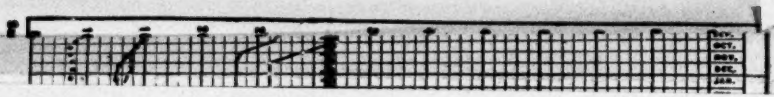

27, 28

Exhibit B

Market history

TANK PLATES, PITTSBURGH, 1895–1924

	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
1924	2.50 c.	2.45 c.	2.40 c.	2.35 c.	2.25 c.	2.15 c.	2.10 c.	2.00 c.	1.95 c.	1.90 c.	1.85 c.	1.90 c.
1923	2.05	2.15	2.35	2.45	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50
1922	1.50	1.40	1.45	1.50	1.60	1.65	1.70	1.80	2.00	1.00	2.00	2.00
1921	2.65	2.35	2.05	2.15	2.20	2.00	1.85	1.75	1.70	2.00	1.60	1.50
1920	3.10	3.70	3.75	3.65	3.50	3.50	3.50	3.50	3.50	3.20	3.00	2.65
1919	3.00	3.00	2.90	2.65	2.65	2.65	2.65	2.65	2.55	2.65	2.65	2.70
1918	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25
1917	4.25	4.30	5.00	5.45	6.40	7.75	9.45	9.20	7.50	3.25	3.25	3.25
1916	2.50	2.55	3.15	3.50	3.50	3.50	3.50	3.75	3.70	3.70	3.90	4.25
1915	1.10	1.10	1.15	1.15	1.15	1.20	1.25	1.30	1.35	1.45	1.70	1.95
1914	1.20	1.20	1.20	1.15	1.15	1.15	1.15	1.15	1.20	1.20	1.10	1.10
1913	1.50	1.50	1.50	1.50	1.50	1.45	1.45	1.45	1.40	1.35	1.30	1.20
1912	1.15	1.10	1.10	1.20	1.25	1.25	1.30	1.35	1.40	1.45	1.50	1.55
1911	1.40	1.40	1.40	1.40	1.40	1.35	1.35	1.30	1.25	1.20	1.10	1.15
1910	1.55	1.55	1.50	1.50	1.50	1.45	1.40	1.40	1.40	1.40	1.40	1.40
1909	1.60	1.45	1.30	1.20	1.25	1.30	1.35	1.40	1.50	1.50	1.55	1.60
1908	1.70	1.70	1.70	1.70	1.70	1.65	1.60	1.60	1.60	1.60	1.60	1.60
1907	1.70	1.70	1.70	1.70	1.80	1.80	1.80	1.70	1.70	1.70	1.70	1.70
1906	1.60	1.60	1.60	1.60	1.60	1.60	1.60	1.60	1.60	1.60	1.60	1.70
1905	1.45	1.50	1.55	1.55	1.55	1.55	1.55	1.55	1.55	1.60	1.60	1.60
1904	1.60	1.60	1.60	1.60	1.60	1.60	1.60	1.60	1.40	1.40	1.40	1.50
1903	1.60	1.60	1.75	1.75	1.60	1.60	1.60	1.60	1.60	1.60	1.60	1.60
1902	1.60	1.60	1.60	1.60	1.60	1.60	1.60	1.60	1.60	1.60	1.60	1.60
1901	1.40	1.40	1.50	1.60	1.60	1.60	1.60	1.60	1.60	1.60	1.60	1.60
1900	2.40	2.20	2.00	1.80	1.60	1.35	1.05	1.10	1.05	1.05	1.35	1.40
1899	1.30	1.45	1.75	2.05	2.10	2.30	2.45	2.55	2.85	2.80	2.50	2.30
1898	1.00	1.00	0.95	1.00	1.10	1.10	1.10	1.10	1.15	1.10	1.10	1.15
1897	1.10	1.10	1.10	1.05	1.05	1.00	1.00	1.00	1.00	1.05	1.00	1.00
1896	1.40	1.35	1.30	1.35	1.30	1.25	1.25	1.20	1.15	1.15	1.10	1.10
1895	1.15	1.10	1.10	1.15	1.20	1.25	1.60	1.70	1.80	1.70	1.60	1.50

29, 30

STRUCTURAL SHAPES, PITTSBURGH, 1895–1924

	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
1924	2.50 c.	2.50 c.	2.50 c.	2.35 c.	2.25 c.	2.20 c.	2.15 c.	2.05 c.	2.00 c.	2.00 c.	2.00 c.	2.00 c.
1923	2.05	2.15	2.35	2.45	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50
1922	1.50	1.40	1.45	1.50	1.60	1.65	1.70	1.80	2.00	2.00	2.00	1.95
1921	2.45	2.25	2.10	2.15	2.20	2.05	1.90	1.75	1.70	1.60	1.60	1.50
1920	2.65	3.15	3.25	3.25	3.25	3.25	3.25	3.15	3.10	3.10	3.00	2.45
1919	2.80	2.80	2.70	2.45	2.45	2.45	2.45	2.45	2.45	2.45	2.45	2.50
1918	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00
1917	3.10	3.25	3.45	3.70	4.00	4.00	4.50	4.50	3.75	3.00	3.00	3.00
1916	1.85	2.05	2.40	2.50	2.50	2.50	2.50	2.50	2.60	2.70	2.90	3.00
1915	1.10	1.10	1.15	1.15	1.20	1.20	1.25	1.30	1.35	1.40	1.65	1.75
1914	1.20	1.20	1.20	1.20	1.15	1.10	1.10	1.15	1.20	1.15	1.10	1.05
1913	1.45	1.45	1.45	1.45	1.45	1.45	1.45	1.45	1.40	1.35	1.30	1.25
1912	1.15	1.15	1.15	1.20	1.25	1.25	1.30	1.35	1.40	1.45	1.50	1.55
1911	1.40	1.40	1.40	1.40	1.40	1.35	1.35	1.35	1.35	1.30	1.20	1.15
1910	1.55	1.55	1.50	1.50	1.50	1.45	1.40	1.40	1.40	1.40	1.40	1.40
1909	1.60	1.45	1.30	1.20	1.25	1.30	1.35	1.40	1.50	1.50	1.55	1.60
1908	1.70	1.70	1.70	1.70	1.70	1.65	1.65	1.60	1.60	1.60	1.60	1.60
1907	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70
1906	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70
1905	1.50	1.55	1.60	1.60	1.60	1.60	1.60	1.60	1.70	1.70	1.70	1.70
1904	1.60	1.60	1.60	1.60	1.60	1.60	1.60	1.60	1.40	1.40	1.40	1.40
1903	1.75	1.60	1.60	1.60	1.60	1.60	1.60	1.60	1.60	1.60	1.60	1.60
1902	1.60	1.60	1.70	1.85	2.00	2.25	2.25	2.35	2.25	2.15	2.10	2.00
1901	1.50	1.50	1.50	1.60	1.60	1.60	1.60	1.60	1.60	1.60	1.60	1.60
1900	2.25	2.25	2.25	2.25	2.25	2.05	1.90	1.75	1.70	1.70	1.70	1.70
1899	1.30	1.30	1.40	1.50	1.50	1.75	1.95	2.05	2.25	2.25	2.25	2.25
1898	1.15	1.15	1.15	1.15	1.15	1.15	1.15	1.20	1.20	1.20	1.20	1.20
1897	1.55	1.55	1.55	1.55	1.30	1.05	1.00	1.00	1.00	1.10	1.10	1.10
1896	1.45	1.50	1.45	1.45	1.50	1.55	1.55	1.55	1.55	1.55	1.50	1.45
1895	1.25	1.20	1.20	1.20	1.20	1.35	1.30	1.60	1.65	1.60	1.60	1.55

32 Now, September 25, 1928, the foregoing stipulation of facts, with Exhibits A, B, and C, certified from the record as a true copy.

B. D. GAMBLE,
Clerk, U. S. Board of Tax Appeals.

[SEAL.]

33 Docket Nos. 6232, 13554

Before United States Board of Tax Appeals

KANSAS CITY STRUCTURAL STEEL COMPANY, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Findings of fact and opinion

Promulgated April 30, 1928

Petitioner maintained a minimum inventory which it priced each year at a figure which represented market in 1916. The inventory in excess of this minimum was valued at cost or market, whichever was lower. The respondent has recomputed the inventory value at market, disregarding the fixed minimum inventory. The determination of the respondent is approved.

Alleged loss in inventory under section 214 (a) (12) disallowed in the absence of evidence to show that materials included in the inventory at the close of the taxable year 1918 were disposed of at a loss during the succeeding taxable year or that such materials remained in the inventory at the close of the taxable year 1919, at which time their value was materially below the value at which they were inventoried at the close of the taxable year 1918.

Phil D. Morelock, Esq., and Armwell L. Cooper, Esq., for the petitioner.

O. Bennett, Esq., for the respondent.

The respondent has determined deficiencies in income and profits taxes for the years 1918 and 1920 in the respective amounts of $38,277.86 and $42,673.14. Only parts of the deficiencies are in controversy.

The petitioner alleges that the respondent erred in increasing its opening and closing inventories for the taxable years, in disallowing a loss in inventory as of December 3-, 1918, due to a decline of prices in March, 1919, and in disallowing a deduction for a bad debt in 1920. No evidence was introduced by petitioner in support of its claimed deduction for a bad debt in 1920 and such contention will be deemed to have been abandoned.

A stipulation of all the facts was entered into by the parties.

34 FINDINGS OF FACT

The petitioner is a corporation organized and existing under the laws of the State of Missouri, with its offices at Kansas City, Missouri.

During the taxable year it was engaged in the fabrication and erection of structural steel plates for buildings, bridges, tanks, etc., and fabricated material for specific structures or contracts. It carried no finished product in stock. Material was ordered and procured from the mills for each specific structure or contract, except

that a supply of material was kept on hand for emergency use to insure the prompt and orderly execution of contracts. When such material was used, it was charged to the contract at its replacement cost and promptly replaced with material of a like kind in a like quantity.

As at December 31, 1916, the company had on hand 5,554 tons of structural steel which it priced at $1.70 per hundredweight f. o. b. Pittsburgh, representing cost price. This price represented the highest normal market encountered since 1895. Beginning with 1916 the price of structural steel advanced suddenly until it reached $4.50 per hundredweight f. o. b. Pittsburgh for structural shapes and $9.45 per hundredweight f. o. b. Pittsburgh for tank plates. On September 24, 1917, the Government fixed the price of steel f. o. b. Pittsburgh as follows:

Structural Shapes	$3.00 per cwt.
Tank plates	3.25 " "

Following the relinquishment by the Government of control, prices per hundredweight f. o. b. Pittsburgh at the close of the taxable years were as follows:

	1918	1919	1920	1921
Structural shapes	2.80	2.65	2.45	1.70
Tank plates	3.00	3.10	2.65	1.80

Petitioner at the end of the years 1916, 1917, 1918, 1919, and 1920 valued its said supply of 5,554 tons at $1.70 per hundredweight f. o. b. Pittsburgh. The total inventory as valued by the company and as valued by the commissioner, together with the difference, follows:

Date	Per company	Per commissioner	Increase
12/31/17	$271,827.87	$402,688.55	$130,860.68
12/31/18	446,984.06	612,833.52	165,849.46
12/31/19	449,976.69	562,992.28	113,015.59
12/31/20	319,189.26	436,302.87	117,113.61

35 The total amount of petitioner's inventory dropped below the 5,554 tons during each year. However, it was replaced before the close of these years, except the years 1917 and 1921. The company had on hand at the stated dates the following amounts of steel in tons:

Date	Amount in tons	Date	Amount in tons
December 31, 1916	5,554	December 31, 1922	9,341
December 31, 1917	5,298	December 31, 1923	8,732
December 31, 1918	5,887	December 31, 1924	10,411
December 31, 1919	6,957	December 31, 1925	7,202
December 31, 1920	7,246	December 31, 1926	8,126
December 31, 1921	4,512		

All materials of like dimensions are piled piece upon piece in perpendicular piles. Material for specific contracts is not included in above figures.

The following tons of steel were fabricated by the company yearly:

1916	27,999 tons.	1922	35,925 tons.
1917	28,319 "	1923	58,124 "
1918	20,266 "	1924	34,425 "
1919	31,432 "	1925	33,105 "
1920	40,827 "	1926	35,863 "
1921	27,040 "		

When the material on hand at the close of the year exceeded 5,554 tons, the excess was priced by petitioner at cost or market, whichever was lower. Beginning with December 31, 1921, and for subsequent years, after prices became normal, the entire inventory was priced by petitioner at cost or market, whichever was lower.

The respondent in recomputing the inventory value for the taxable years has disregarded the fixed quantity of 5,554 tons and priced the entire inventory at market, as shown by petitioner's most recent purchases.

In March, 1919, between the 20th and 27th, market prices were reduced from those which prevailed when the inventory was priced December 31, 1918, to the following:

36	Tank plates	$3.24 per cwt. f. o. b. Kansas City.
	Steel bars	2.94 " " " " "
	Structural shapes	3.04 " " " " "

Steel prices remained relatively constant throughout the remainder of the year 1919.

During the first three and one-half months of 1919 the company sold and withdrew from stock:

January	1,507,930 pounds.
February	1,545,411 "
March, 1/2 of tonnage	738,413 "
	3,791,754 pounds of steel.

There were on hand at December 31, 1918, 11,774,497 pounds of steel. After subtracting therefrom the 3,791,754 pounds withdrawn from December 31, 1918, to March 16, 1919, there remained on hand March 15, 1919, 7,982,743 pounds of steel. No physical inventory was taken on March 15, 1919. In allocating the tonnage to the following classifications the same proportion has been applied to the 7,982,743 pounds as existed with respect to the inventory at December 31, 1918:

Balance 3/15/19, 7,982,743 lbs., $3.4544		$275,755.84
Tank plates, 4,375,763 lbs., $3.24	$141,744.72	
Steel bars, 565,222 lbs., $2.94	16,617.53	
Structural shapes, 2,914,294 lbs., $3.04	88,594.54	
Scrap iron, 127,464 lbs., $1.00	1,274.64	
		248,261.43
Loss in inventory claimed by petitioner		27,494.41

The 3.4544 applied as a multiple in arriving at the value of the 7,982,743 pounds of steel on hand as at March 15, 1919, is the average price of the composite inventory as at December 31, 1918, as established by the respondent. The prices applied as multiples to the classes of material as at March 15, 1919, in computing the value of each class, are taken from the Iron Trade Review, plus 59 cents freight per cwt. to Kansas City.

No claim for abatement was filed under the provisions of section 214 (a) (12) (a) of the revenue act of 1918.

37 OPINION

LANSDON: There are two questions presented for determination: (1) Which of two methods of inventory more clearly reflects the income, and (2) whether petitioner is entitled to deduct from its income for 1918 an alleged loss in inventory resulting from a decline in price of structural steel in March, 1919.

With regard to the first question, section 203 of the revenue act of 1918 provides:

"That whenever in the opinion of the commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the commissioner, with the approval of the secretary, may prescribe as conforming as nearly as may be best accounting practice in the trade or business and as most clearly reflecting the income."

On December 31, 1916, petitioner had on hand 5,554 tons of structural steel which it priced at $1.70 per hundredweight f. o. b. Pittsburgh, representing cost price. At the close of each of the years following until 1921 it valued its inventory by considering the 5,554 tons as constituting a fixed stock or minimum inventory which it priced at $1.70 per hundredweight. That part of the inventory which exceeded 5,554 tons was priced by petitioner at cost or market, whichever was lower. Each year an undetermined portion of the 5,554 tons was sold and replaced at a price substantially in excess of that used in valuing the 5,554 tons.

The respondent in recomputing the inventory value has disregarded the fixed quantity as used by the petitioner and has priced the total inventory at market.

The petitioner contends that the method used by the respondent reflects fictitious profits during the years of rapidly advancing prices and that this fictitious profit was eliminated in 1920 when prices again became normal. It contends, however, that in the meantime it has been subjected to a tax on this fictitious profit.

In the following regulation the commissioner has approved a basis for valuing inventories, the express purpose of which is to make it unnecessary to report fictitious profits:

"ART. 1582. [REGULATIONS 45.] Valuation of inventories: Inventories must be valued at (a) cost or (b) cost or market,
38 whichever is lower. * * * Whichever basis is adopted must be applied consistently to the entire inventory. * * *

Goods taken in the inventory which have been so intermingled that they can not be identified with specific invoices will be deemed to be the goods most recently purchased."

The petitioner has not elected to price its inventories at cost or market, whichever is lower.

Material was continually used by petitioner from the stock on hand to finish out contracts and for other emergency use. The contract price was computed on a basis of the then market price, which during the period of steadily advancing prices produced a substantial profit which included the increase in value. Petitioner's theory is that this profit derived from the increase in value was replaced in the inventory by repurchasing steel at advanced prices. It was profit realized, nevertheless, and it is none the less taxable because it was immediately reinvested in inventory.

The method used by the petitioner in valuing its inventory, which has been known to accounting as the "minimum," "cushion," "base-stock," or "constant average" method of inventory and hereinafter referred to as the minimum-inventory method, does not conform to the best accounting practice in trade or business. This method has not been widely adopted, and to sanction it in the case of the very small minority of taxpayers who have used it as petitioner has, only for a period of a few years, would work an unjustifiable discrimination against the great majority of manufacturers and dealers who have not used it.

The income-tax system is based upon an annual accounting period. The object of the inventory is to assign to each accounting period its profits and losses. The effect of the minimum-inventory method is to assign all profits and losses to the year in which this minimum inventory is liquidated. In fact, however, each sale or exchange of the individual items of the inventory is a realization of taxable profit or deductible loss in the year in which it occurs, and a method of accounting which disregards such realization does not truly reflect income. After the profit is realized it is immaterial whether it is immediately reinvested in inventory or is invested in some other manner. It is taxable when realized.

The practical result of the use of this method of inventory is to offset an inventory gain of one year against an inventory loss
39 of another year rather than to assign to each year its true gain or loss. Its use arises from a desire to play safe and provide reserves against possible future losses. The fact that sections 204, 214 (a), and 234 (a) of the revenue act, of 1918 authorize in some cases the carrying of a loss realized in one year into accounts of another year indicates that Congress did not intend that the ordinary inventory provisions should be construed to authorize such a transfer.

The evidence establishes clearly that some undeterminable part of the steel on hand in 1916 remained during the taxable years. All material of like dimensions was piled piece upon piece in perpendicular piles, with the result that the material most recently purchased

was in fact first used. If petitioner had used some means to identify the material so that its inventory could have been priced at cost, it might have obtained a more favorable result than that obtained through respondent's determination, which we are disposed to approve. The material in the inventory, however, is unidentifiable, and there has been offered no basis upon which we can determine cost of the inventory. The respondent computed the inventory value at market as disclosed by petitioner's most recent purchases, and adjusted both the opening and closing inventories for the taxable years on this basis. The determination of the respondent is approved.

Petitioner's second contention is that it is entitled to deduct from its net income for 1918 a loss in inventory sustained in March, 1919. Sections 214 (a) (12) and 234 (a) (14) of the revenue act of 1918 provide in part:

"At the time of filing return for the taxable year 1918 a taxpayer may file a claim in abatement based on the fact that he has sustained a substantial loss (whether or not actually realized by sale or other disposition) resulting from any material reduction (not due to temporary fluctuation) of the value of the inventory for such taxable year, or from the actual payment after the close of such taxable year of rebates in pursuance of contracts entered into during such year upon sales made during such year. * * * (b) If no such claim is filed, but it is shown to the satisfaction of the commissioner that during the taxable year 1919 the taxpayer has sustained a substantial loss of the character above described, then the amount of such loss shall be deducted from the net income for the taxable year 1918 and the tax imposed by this title for such year shall be redetermined accordingly. Any amount found to be due to the taxpayer upon the basis of such redetermination shall be credited or refunded to the taxpayer in accordance with the provisions of section 252."

During the first two and one-half months of 1919 petitioner withdrew from stock and fabricated for use under its contracts approximately one-third of the material contained in its closing inventory for 1918. We believe it is reasonable to assume that the remaining two-thirds was withdrawn from stock for similar use during the last nine and one-half months of 1919. The petitioner has not shown that any part of such material was sold at a loss. Neither has it shown that any of the material contained in its closing inventory for 1918 remained in stock at the close of the year 1919. If a reduction in market value of the items of inventory actually results in a loss, petitioner is entitled to a deduction under sections 214 (a) (12) and 234 (a) (14) of the revenue act of 1918. If during the year 1919 petitioner succeeded in retailing or manufacturing and selling without loss the goods contained in its closing 1918 inventory, it is entitled to no deduction, though the market value has been materially reduced. In Appeal of Carlisle Garment Co. (3 B. T. A. 1119), where it was held that in the absence of evidence that the inventory was sold at a loss during 1919 there could be no deduction from the 1918 income, the board stated at page 1123.

"A material reduction of the value of an inventory is not, in itself, sufficient to sustain a claim for a loss under this section. The material reduction must result in a substantial loss. * * * It appears further that the taxpayer manufactured the goods in its inventory at the close of 1918 and sold them during the year 1919. It does not appear that any loss whatever was sustained by the sale of these inventoried articles, nor does it appear that they were on hand at the close of 1919, included in the inventory of that year, or that the raw material content at that time of such inventoried goods, even if they were on hand at the close of 1919, could have been inventoried at a market value of less than cost. Under these circumstances, there is no evidence that the taxpayer has sustained a substantial loss resulting from any material reduction in the value of the inventory as taken at the close of 1918, and it is therefore not entitled to deduct the amount of the loss claimed for that year."

See also Appeal of Hayes Textile Co., Inc., (4 B. T. A. 1274), and Appeal of Otto A. Altschul (5 B. T. A. 53).

The evidence is clear that a material reduction occurred in the market value of petitioner's inventory in March, 1919. The evidence does not convince us, however, that petitioner has thereby sus-
41 tained a substantial loss, and it is therefore not entitled to the deduction claimed under sections 214 (a) (12) and 234 (a) (14) of the revenue act of 1918.

Judgment will be entered for the respondent.

Reviewed by the board.

Murdock concurs in the result.

Smith and Green dissent.

[Certificate to foregoing paper omitted in printing.]

Before United States Board of Tax Appeals, Washington

Docket No. 6232

KANSAS CITY STRUCTURAL STEEL COMPANY, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Order of redetermination

April 30, 1928.

Pursuant to the board's findings of fact and opinion, promulgated April 30, 1928, it is

Ordered and decided: That upon redetermination there is a deficiency for the year 1918 in the amount of $38,277.86.

(Signed) W. G. LANSDON,
Member, United States Board of Tax Appeals.

Entered Apr. 30, 1928. Dated Washington, D. C. Enter.

[Certificate to foregoing paper omitted in printing.]

42 Before United States Board of Tax Appeals

Docket No. 6232

KANSAS CITY STRUCTURAL STEEL COMPANY, A CORPORATION, petitioner

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Petition of Kansas City Structural Steel Company for review of decision of United States Board of Tax Appeals

The above-named Kansas City Structural Steel Company, a corporation, hereinafter called petitioner, respectfully declares and shows:

I

This is a proceeding for the review of a decision of the United States Board of Tax Appeals rendered and promulgated on April 30, 1928, determining that there was a deficiency tax of thirty-eight thousand two hundred seventy-seven and 86/100, ($38,277.86) dollars in the Federal income tax of the petitioner for the year 1918.

II

The petitioner is a corporation duly organized and existing under and by virtue of the laws of the State of Missouri, and having its principal office in Kansas City, Missouri, and duly and timely made its income-tax return for the year 1918 to the collector of internal revenue for the sixth district of Missouri, in which district Kansas City, Missouri is located.

III.

Petitioner seeks said review of said decision of the United States Board of Tax Appeals by the United States Circuit Court of Appeals of the Eighth Judicial Circuit. Said city of Kansas City, Missouri, and said district are located in said Eighth Judicial District. Said United States Circuit Court of Appeals of said Eighth Judicial Circuit has jurisdiction to review said decision of said United States Board of Tax Appeals.

IV

The nature of the controversy herein is as follows:

Petitioner was engaged in the business of fabricating and erecting, by contract, structural steel and steel plates for buildings,
43 bridges, tanks, and other structures, and fabricated and erected such material for each specific structure and contract and carried no finished product in stock. Material was ordered and procured from the rolling mills for each specific structure and

contract. However, a supply of material was kept on hand for emergency use only (under the practice herein set forth) to insure the prompt and orderly execution of contracts, in view of delays incident to shipments from the mills and other exigencies affecting the availability for use, when needed, of material ordered for particular and specific jobs. When in such emergencies material was so used from such supply, it was, upon receipt of the like material previously ordered for the particular job upon which such material was used, promptly replaced with material of a like kind and in a like quantity, thereby effecting an exchange of material, kind for kind and quantity for quantity. This practice was fixed and was consistently adhered to. Petitioner was not a merchant, and such material was not for sale and did not constitute a merchandising stock. On the contrary, it was a contractor for the delivery to its customer of the completed structure in place, involving and embracing all labor and material. The material was very heavy and was kept in convenient piles of like kind. When material was so used, it was taken from the top of the pile and when replaced was put on top of the pile from which the used material was taken or borrowed. The amount of such material on hand on December 31, 1916, was 5,554 tons, which petitioner set aside and substantially maintained for the emergency used under the practice aforesaid (and not otherwise), and priced it at its base cost of $1.70 per cwt. f. o. b. Pittsburgh, Pa., or with the freight added, at $2.136 per cwt. f. o. b. Kansas City, Missouri. This price also represented the highest normal market encountered since 1895. Petitioner contends that said fixed quantity of material should be regarded as a fixed asset and facility maintained for emergency use under the practice of exchange or borrowing and replacement aforesaid, and that no profits or income did or could accrue therefrom as a basis for the imposition of the tax complained of. Notwithstanding this contention and in disregard thereof, the Commissioner of Internal Revenue priced the same at the end of the year at the cost of a corresponding quantity of the most recent purchases of similar material and imposed a tax upon an erroneously assumed and fictitious income based upon the mere growth and increment in value of the said emergency material, viz, the difference between the value thereof as determined by the commisioner as of December 31, 1917, and the value
44 thereof as so determined by the commissioner as of December 31, 1918. This resulted in a fictitious increase of petitioner's taxable income of eighteen thousand two hundred thirty and 10/100 ($18,230.10) dollars, and an additional or deficiency tax of approximately seven thousand six hundred fifty-six and 74/100 ($7,656.74) dollars. An appeal was taken to the United States Board of Tax Appeals, which affirmed the action of the Commissioner of Internal Revenue and entered judgment acordingly. This appeal is from its action and judgment in that regard.

V.

Petitioner complains of the errors committed by the United States Board of Tax Appeals and says that said board erred in the following particulars:

1. In applying to petitioner's fixed quantity of emergency material the rules applicable to merchandising inventories.

2. In holding and deciding that material removed or borrowed from the emergency supply of material was sold at a profit and the proceeds invested in the replacement material.

3. In holding and deciding that each exchange of individual items of the emergency supply of material was a realization of taxable profit in the year in which it occurred, and that a method of accounting which disregards such realization does not truly reflect income.

4. By failing to recognize and hold that the 5,554 tons of steel was in fact a plant facility and convenience and not merchandise for sale and that it was and had been properly maintained as such for a period of years.

5. In holding and deciding that the growth and increment in value of the emergency supply of material was taxable income.

6. In not holding and deciding that under the agreed facts the judgment should be for petitioner.

7. Under the decision in this case and the interpretation placed upon the income tax law by the United States Board of Tax Appeals the said law is in conflict with and violation of the sixteenth amendment to the Constitution of the United States in that it permits the assessment and imposition of an income tax when there is no income in fact.

8. As to the other questions and taxes involved under the pleadings and agreed statement of facts filed with the said board petitioner assigns no error.

45 Wherefore petitioner respectfully prays the honorable United States Circuit Court of Appeals for the Eighth Judicial Circuit to reverse the decision rendered in the above-entitled cause by said United States Board of Tax Appeals, as aforesaid, and to decide that the additional or deficiency income tax complained of should not be assessed against petitioner and to award petitioner such other and further relief as may be just and proper, together with the costs taxable herein.

[SEAL] KANSAS CITY STRUCTURAL STEEL COMPANY,
By HOWARD A. FITCH. (Sgd.)
Attest: JOHN R. COOPER, (Sgd.)
Secretary.

ARMWELL L. COOPER, (Sgd.)
ELLISON A. NEAL, (Sgd.)
WHITSON ROGERS, (Sgd.)
Attorneys for Petitioner.

[*Duly sworn to by Howard A. Fitch; jurat omitted in printing.*]

[Certificate to foregoing paper omitted in printing.]

46 Before United States Board of Tax Appeals

Docket No. 6232

KANSAS CITY STRUCTURAL STEEL COMPANY, A CORPORATION, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Notice of petition for review

Filed Sept. 19, 1928

To the COMMISSIONER OF INTERNAL REVENUE:

Please take notice that the above-named petitioner has this day filed with the clerk of the United States Board of Tax Appeals a petition for review by the United States Circuit Court of Appeals for the Eighth Judicial Circuit of the decision rendered and promulgated in the above-entitled cause by said United States Board of Tax Appeals, and that a copy of said petition for review and of the præcipe for transcript are herewith delivered to you and served upon you by said petitioner.

Dated this 17th day of September, 1928.

ARMWELL L. COOPER,
ELLISON A. NEEL,
WHITSON ROGERS,
Attorneys for Petitioner.

COOPER & NEEL,
Of Counsel.

Due service, on this 19th day of September, 1928, of the above and foregoing notice, and of the petition for review and præcipe for transcript mentioned in said notice, is hereby acknowledged.

C. M. CHAREST,
General Counsel, Bureau of Internal Revenue.

[Certificate to foregoing paper omitted in printing.]

47 Before United States Board of Tax Appeals

Docket No. 6232

KANSAS CITY STRUCTURAL STEEL COMPANY, A CORPORATION, petitioner

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Præcipe for transcript

To the CLERK OF THE UNITED STATES BOARD OF TAX APPEALS:

The above-named petitioner, in connection with its petition for the review of the decision of the United States Board of Tax Appeals in the above-entitled cause by the United States Circuit Court

of Appeals for the Eighth Judicial Circuit, hereby requests you to prepare, certify, and transmit to the clerk of said court a transcript of the record in said cause and to include therein the following:

1. The docket entries of the proceedings before said United States Board of Tax Appeals.
2. The pleadings before said United States Board of Tax Appeals.
3. The agreed statement of facts filed in said cause.
4. The findings of fact, opinion, and decision of said United States Board of Tax Appeals.
5. The petition of said petitioner for said review.
6. The notice of the Commissioner of Internal Revenue of the filing of said petition and his acknowledgment of service.
7. This præcipe.

ARMWELL L. COOPER,
ELLISON A. NEEL,
WHITSON ROGERS,
Attorneys for said Petitioner.

[Certificate to foregoing paper omitted in printing.]

48 [Appearances of counsel omitted in printing.]

49 [Minute entry of argument and submission, Jan. 24, 1929; omitted in printing.]

50 In United States Circiut Court of Appeals, Eighth Circuit

No. 8358, May term, A. D. 1929

KANSAS CITY STRUCTURAL STEEL COMPANY, APPELLANT,

vs.

COMMISSIONER OF INTERNAL REVENUE, APPELLEE

On petition to review decision of the United States Board of Tax Appeals

Before LEWIS, Circuit Judge, and WOODROUGH and MCDERMOTT, District Judges

Opinion

Filed May 14, 1929

MCDERMOTT, District Judge, delivered the opinion of the court.

This appeal brings on for review a decision by the Board of Tax Appeals sustaining a deficiency assessment against the appellant in the sum of $7,656.74. The case was presented to the board
51 upon a stipulation of facts. The board made findings of fact which are substantially as stipulated. There is no record of

any evidence being offered in addition to the stipulation, except that the opinion states—

"The evidence establishes clearly that same undeterminable part of the steel on hand in 1916 remained during the taxable years."

Whether there was other evidence of this fact is not material, for it is a natural inference deducible from the facts stipulated and found.

The question presented is whether, in arriving at the taxable income of the appellant, the commissioner had a right to consider the inventory value of a stock of steel, set apart by the appellant as an "emergency" or "reserve" or "stand-by" stock.

It is stipulated that:

"The company is engaged in the fabrication and erection of structural steel plates for buildings, bridges, tanks, etc. It fabricates material for specific structures or contracts and carries no finished product in stock. Material is ordered and procured from the mills for each specific structure or contract, except that a supply of material as shown in Exhibit A has been kept on hand for emergency use (from which material is borrowed and replaced) to insure the prompt and orderly execution of contracts in view of delay, etc., incident to shipments from the mills and other exigencies affecting the availability for use when needed of material ordered for a particular job. When such material is used it is charged to the contract at its replacement cost and is promptly replaced with material of a like kind and in a like quantity."

Upon argument it was stated and not denied that the business of the taxpayer consisted, in large part at least, of bidding for the steel work of buildings and bridges and other structures where steel is used; these bids are predicated upon firm offers procured from the mills for the steel involved, plus the cost of fabrication and a profit. If the bid was accepted, the materials were ordered for the job. This seems to be the only inference that can be drawn from the facts stipulated, to wit, "It fabricates material for specific structures or contracts and carries no finished product in stock" and "material is ordered and procured from the mills for each spe-
52 cific structure or contract." The taxpayer's business is closely akin to that of a building contractor, which, as far as steel is concerned, it is.

It is further stipulated that this emergency reserve consisted of 5,554 tons of structural steel, being the amount on hand on December 31, 1916. Its cost was $1.70 per cwt. f. o. b. Pittsburgh. It is stipulated that this price of $1.70 "represented the highest normal market encountered since 1895." From that date on until December 31, 1921, this steel was treated as above stipulated. All materials of like dimensions were piled piece upon piece in perpendicular piles. This stock varied in size during the year, being both below and above the 5,554 tons as material was used therefrom and replaced therein, the extreme limits from 1916 on, for any part of the year, being approximately 4,000 and 11,000 tons. Except for the years 1917 and 1921,

the reserve exceeded 5,554 tons on December 31 of each year. These years are not in controversy and the shortage was inconsiderable. Whenever the reserve exceeded 5,554 tons on December 31, the excess was valued at current prices and a tax paid thereon.

In figuring up its taxable profit for the years 1918 to 1920, inclusive, the appellant treated this emergency steel as a part of its fixed equipment and carried it at the 1916 cost price of $1.70 per cwt. The stipulation states:

"The company, at the end of the years 1916, 1917, 1918, 1919, and 1920, valued its said supply of 5,554 tons at the cost price prevailing at the close of 1916, or $1.70 per hundred weight f. o. b. Pittsburgh."

Since the reserve did not consist of the identical pieces in the pile on December 31, 1916, and which cost $1.70 per cwt., and since it was impossible to ascertain the cost of the steel actually in the pile, the commissioner inventoried the entire stock at the market price of the steel most recently purchased, under the rule prescribed by article 1582, regulation 45, that the presumption is "the first in, the first out." Whether this presumption is a fair one in the face of the actual probability that workmen would take a girder off the top of a pile instead of the bottom is challenged by the appellant, but need not be considered.

53 The result of the two methods of pricing the inventory was that the Government figured the income of the appellant to be $18,230.10 more than the appellant figured it. A deficiency assessment of $7,656.74 was made, and an appeal to the Board of Tax Appeals was unsuccessful, and the case is here on review.

Since the taxpayer figured this emergency steel as a part of its fixed equipment, no claim was filed for abatement under sections 214 (a) (12 and 234 (a) (14 of the revenue act of 1918 for inventory losses occurring when prices began to fall. On December 31, 1921, "after prices became normal" and when the price of the steel had dropped below the 1016 level ($1.50) the taxpayer acquiesced in the Government position, and the emergency reserve was priced by the taxpayer at its cost, or market, whichever was lower. It will thus be seen that the taxpayer had 5,554 tons of $1.70 steel on hand on December 31, 1916, and 5,554 tons of $1.50 steel of a like kind and in a like quantity on hand on December 31, 1921, and that no income had been enjoyed by the taxpayer through its maintenance of this reserve during the five years.

While no claim for abatement was made under the cited sections of the 1918 law, as recited in the stipulation, it does appear that before the Board of Tax Appeals the taxpayer asked credit for a loss in the inventory, due to the falling market in the year 1919. This claim is inconsistent with its present contention, and the record is not clear as to whether the taxpayer asserted this claim as a counter attack after the Government had asserted the right to tax the paper profits on the same steel during the advancing prices. The Board of Tax Appeals upheld the Government's right to tax the

profit on the advancing market, but denied the taxpayer the credit for losses on the falling market because they were not actual losses. The taxpayer has not appealed from that part of the order, but insists that if the board denies a credit for losses because they are not actual it ought not to tax income unless it is realized.

The good faith of the taxpayer is not questioned. The stipulation sets out facts indicative of good faith. The reserve was set apart when prices were at the highest level since 1895; during the succeeding years its market value doubled, and yet the taxpayer did not liquidate it and take its profit; it kept it until prices were below the 1916 level, and it showed a loss; although the amount
54 actually on hand, at the close of the year, was sometimes much more than 5,554 tons, it accounted for the excess to the Government. It must be assumed that the reserve was in fact maintained, for the purpose as stipulated, and it was reasonable in amount.

It will be seen at once that the underlying question is the propriety of including tnis reserve supply in an inventory taken as an aid to the ascertainment of income. Before dealing with that it may be as well to consider one or two arguments made by the Government in support of its position. It is urged that in 1921, when prices had gone down, the appellant itself included the entire emergency reserve at 1921 prices and that the taxpayer applies one rule when prices are high and another when prices are low. The Government makes the very sound argument that one of the prime requisites of any tax system is consistency; that when a tax-payer has adopted one system, it should be adhered to, in fair weather or in foul; and that no tax-payer should be permitted to play fast and loose with his Government. This very fair and sound rule does not apply, however, where the tax-payer changes his position at the Government's requirement; if the appellant is right in its contention, it cannot be denied relief because it, although still protesting, acquiesced in the ruling, either because the drop in price had eliminated any substance to the disagreement or because it became weary of the contest. It is also urged that the appellant, during these very years, included as a part of its income, the increase in value of the excess of the emergency steel over 5,554 tons, and thereby attested the correctness of the Government's position. The conclusion does not follow. As to the excess, the appellant doubtless recognized that an emergency supply must bear a fair proportion to the requirements of the business; having determined that 5,554 tons was an adequate reserve for a business that fabricated about 30,000 tons a year, it should account for any excess above that amount. Moreover, that the tax-payer may have paid more taxes than it should have is not adequate reason for a disposition of this case. The Government urges that this is but another claim of the right to set up a "minimum inventory" formerly but unsuccessfully claimed by retailers and dealers. If it is, then the appeal must fail; but that

is to assume the correctness of the real controversy, to which we now turn.

55 Inventories reflect what a man has, and not what he earns; they reflect capital, and not income; many times in practice they distort income. Many a merchant has paid an income tax predicated upon the cost or market of goods on his shelves, only to find that by the time the goods were sold he had sustained a loss instead of a profit. The bankruptcy courts of the deflation period were flooded with claims of unpaid income taxes of the preceding years, a taxation on an income never in fact realized—a paper profit in an inventory which was turned into a loss in a few short months.

The use of inventories to reflect income is resorted to from necessity. There are a great many business institutions that must either take into account their inventories or not compute their income at all. It is a financial if not a practical impossibility to ascertain the cost and selling price of each spool of thread sold by a retailer or each sack of flour made by a miller. If it could physically be done, the cost of the bookkeeping would be more than the gross receipts; hence not only the propriety, but the necessity, of the use of inventories in certain lines of business.

The statute recognizes this, and the statutory power to use inventories is predicated upon necessity. Section 203 of the revenue act of 1918 provides:

"That whenever in the opinion of the commissioner the use of inventories is necessary in order clearly to determine the income of any tax-payer, inventories shall be taken by such tax-payer upon such basis as the commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

The regulation enacted in pursuance thereto provides (art. 1581, Reg. 45):

"In order to reflect the net income correctly, inventories at the beginning and ending of each year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor."

Foulke on The Federal Income Tax (sec. 642) says:

"Inventories are necessary in business affairs according to the exigencies of each particular case. The statute provides that
56 inventories shall be used in income-tax accounting whenever necessary in the opinion of the commissioner to clearly determine income. The commissioner thus has discretion to determine whether or not in fact inventories are necessary and which discretion is no doubt subject to review by the court, although no case appears to have yet arisen. Inventories are necessary in those cases where owing to the quantity of goods or commodities involved in the transaction it is not practicable to keep a separate account of each piece. An inventory is simply a lumping method of determining the

gain or loss on the conversion of property in quantities where there is a fluctuation from year to year of the amount on hand, with a practical impossibility of separately itemizing the articles which are added or taken away."

It might correctly be said that the appellant is a fabricator, a constructor, and is not engaged in either the "production, purchase, or sale of merchandise," except as incident to its work of construction, just as a builder of houses buys lumber and nails, and gets a lump sum for the finished product. But we prefer that the decision rest on broader grounds.

At the outset it should be remembered that a wide discretion is vested in the commissioner, and not in the courts, and if the business is one where there is any substantial evidence indicating the necessity for the use of inventories, his decision, backed by majority opinion of the Board of Tax Appeals, should not be disturbed. On the other hand, if under the agreed facts a situation is presented where it is clear that the use of an inventory is not only not necessary, but as a matter of fact distorts rather than reflects income, then the appellant has a right to invoke the aid of the courts.

In approaching the problem it should be remembered that all of acts of the commissioner, all of the Treasury regulations, all of the taxing statutes, draw their vitality from the sixteenth amendment to the Constitution, which gives to Congress the "power to lay and collect taxes on incomes." The Supreme Court said:

"Congress cannot by any definition it may adopt conclude the matter, since it cannot by legislation alter the Constitution, from which alone it derives its power to legislate, and within whose
57 limitations alone that power can be lawfully exercised." (Eisner v. Macomber, 252 U. S. 189.)

See, to the same effect, Taft v. Bowers, decided by the Supreme Court of the United States February 18, 1929, and not yet reported.

The taxing statutes and the regulations prescribe rules and regulations as aids in arriving at true income and are not designed to create income. In all tax matters, as in most others, the form must give way to the substance. (Eisner v. Macomber, supra; Bowers v. Kerbaugh, 271 U. S. 170; Tucker v. Alexander, 25 F. (2d) 425 (8 C. C. A.).) The provisions of the statute or regulations should not be extended, by implication, beyond the clear import of the language used. "Doubts are resolved against the Government." (Gould v. Gould, 245 U. S. 151; U. S. v. Merriam, 263 U. S. 179; Hellmich v. Hellman, 18 F. (2d) 239 (8 C. C. A.).) And Judge Van Valkenburgh, now of this court, has said:

"This is, of course, the fundamental purpose of the law that the taxpayer should be taxed upon his actual income and that this should neither be diminished nor increased by any arbitrary or artificial method of computation. As the laws say, 'the true income must be clearly reflected,' and for this purpose the regular and long-stand-

ing methods of accounting employed by the taxpayer, established in due course and for no ulterior purpose, are to be indulged.

"* * * But if the books are kept, as the record shows they are, to show the exact state of the income upon completed contracts in each year, it is not perceived how greater difficulty can arise in the case of engineers than in that of building and construction work generally. Furthermore, the Government does not seek to secure a return upon income which is not accurate in fact and which casts an unjust burden upon the taxpayer." (In Re Harrington, 1 F. (2d) 749.)

Income has been authoritatively defined as "the gain derived from capital, from labor, or from both combined," and in referring to that definition the Supreme Court has said:

"Brief as it is, it indicates the characteristic and distinguishing attribute of income, essential for a correct solution of the
58 present controversy. The Government, although basing its argument upon the definition as quoted, placed chief emphasis upon the word 'gain,' which was extended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived—'*derived from capital*,' '*the gain derived from capital*,' etc. Here we have the essential matters—*not* a gain *accruing* to capital, not a *growth* or *increment* of value *in* the investment, but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital, however invested or employed, and *coming in*, being '*derived*,' that is, *received or drawn by* the recipient (the taxpayer) for his separate use, benefit, and disposal; *that* is income derived from property. Nothing else answers the description." (Italics by the court.) Eisner v. Macomber, 252 U. S. 189.)

The regulations can not be broader than the statute. The statute authorizes the use of inventories, when "in the opinion of the commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer * * *." While no case has apparently decided the question, it is undoubtedly true that the opinion of the commissioner must be predicated upon facts reasonably justifying it; it may not be arbitrary. (Foulke on The Federal Income Tax, sec. 642.)

Is there any basis for determining that an inventory of this emergency steel is necessary in arriving at appellant's income prior to the time when it is liquidated? It is stipulated that the appellant "carries no finished product in stock"; that is, unlike a retailer or wholesaler or a miller, it is not a dealer. "It fabricates material for specific structures or contracts"; that is, it gets a contract first and then does the work. Except for the supply in question, and the excess inventory on which taxes are paid, "material is ordered and procured from the mills for each specific structure or contract"; that is, it buys on the market and at the market for each job. Some-

times when work is progressing the material ordered is delayed in shipment or transit; rather than delay the job, then and then only—"for emergency use (from which material is borrowed and replaced)"—the reserve steel in question is resorted to. When it is so used, "it is charged to the contract at its replacement cost and
59 is promptly replaced with material of a like kind and in a like quality"—presumably, as stated in argument, from the delayed car.

We have then this situation: The appellant is fabricating steel at Kansas City, some distance from steel mills; realizing the chance of delayed shipments, and in order to be able to compete in prompt execution of its contracts with other plants located near the mills, it carries a "stand-by" stock, replacing each girder used therefrom by the one ordered. There is in fact no profit at all realized from this emergency supply other than the reputation of promptly doing the work. The profit of each job is exactly the same as if it had no such reserve. The profit is the same as if it borrowed the steel from a neighbor instead of from this pile. In fact, it might very well be that half this reserve steel would go into a bridge that showed a loss on the entire contract. The pile is the same on December 31, 1916, as it is on similar days in each succeeding year, except for the two years noted and not here involved. As long as it remains intact there is no income from it, no matter what the market fluctuations are. When, if ever, it is liquidated, there will then be a profit or loss, but until then it is like its derricks and its cranes and its buildings; it is useful in the business, but until liquidated can show only paper profits which are neither realized nor taxable.

Upon argument it was urged that when the taxpayer took $1.70 steel out of the pile and put it in a $4.00 contract he made a profit, and whether he reinvested that profit in other steel that went into the pile is immaterial. This overlooks the stipulated facts. The taxpayer's contract was figured on $4.00 steel which he ordered from the factory; if a $1.70 girder was "borrowed" from the pile to-day, put into a bridge, and "replaced" to-morrow in "kind" with a $4.00 girder, there is no profit as long as he keeps the $4.00 girder for emergency use. In the briefs it is argued that the appellant is like a merchant, who constantly replenishes his stock, always striving to keep a stock on hand to meet the demands of his trade. That but begs the question. In the first place, inventories are "necessary" for the multitudinous transactions of merchants, who buy first and sell afterward; they are not necessary for those who keep no finished stock, who sell no goods, and who always
60 contract first and buy afterward. Moreover, merchants keep no stand-by stock for years, promptly replacing in kind each item borrowed therefrom.

Taking the whole business of the taxpayer, as stipulated, and bearing in mind the admonition that the substance and not the form

controls, we cannot escape the conclusion that, as a matter of fact, the existence or absence of this emergency supply doesn't add a dollar to the profit the taxpayer made on any contract he has ever executed; under the facts it cannot affect his income, except as a good reputation helps him to other contracts, upon which he will pay a tax. When he abandons or cuts down the emergency pile, then he must account for his profit over the 1916 price of $1.70; but, like his cranes and derricks, until he does dispose of them, no taxable income accrues from the mere ownership. The facts in this case show that on December 31, 1916, this steel cost the taxpayer $1.70 per cwt. All during the years he kept it up and used it as an emergency reserve; in December, 1921, it took it into account for tax purposes, a theoretical liquidation. On that date it was worth $1.50 per cwt., twenty cents less than it paid for it in 1916. Yet by virtue of its ownership the Government has assessed a tax predicated on a profit of $18,000.00. True income must be on an annual basis, and losses of this year may not offset profits of last. But here there was no actual profit in any year and no actual profit when liquidated. An Iowa farmer who owned $150.00 an acre land in 1916, and who sold it in 1924 for $150.00 an acre, cannot be taxed because in 1918 or 1919 it had a market value of $300.00 an acre. This analogy, it is true, overlooks the specific individuality of two identical girders which may be interchanged one day with the next—"borrowed" and "replaced." But that is of the form rather than of the substance. The appellant derived no income during the years from the ownership of this emergency supply; it was a part of its equipment for doing business; its business was such that it was not necessary to include it in the inventory to arrive at actual income; to so consider it distorts rather than reflects the true income of the taxpayer.

This decision is necessarily confined to the facts of this particular business. If the appellant were a merchant or a manufacturer, where inventories were necessary to arrive at income, it must take into account all of its stock, and cannot set apart a "minimum" in-
61 ventory. If the appellant, a builder, used this emergency supply for tucking away profits actually made, it could not escape. If there was bad faith, or an excessive reserve, it would be otherwise. If it liquidated the pile and took its profit, it must pay. But these are not the stipulated facts. The stipulated facts show a builder who keeps a supply of building materials against an emergency; it is reasonable in amount; it does not liquidate it on a high market and take its profit; it held it for years as a part of its fixed equipment; it never made a dollar out of it except as it enabled it to secure other contracts on the profits of which it paid a tax; its existence produced no income, and there should be no tax.

The order appealed from in this case, and in No. 8359, stipulated to abide this case, are reversed.

In United States Circuit Court of Appeals

Dissenting opinion

Filed May 14, 1929

WOODROUGH, District Judge, dissenting:

The tax-payer being a contractor, of course its true income for any year was the difference between the receipts from its contracts and the cost to it of fulfillment, due allowances being made. Obviously the collector could not get at this amount from the book figures of the company, because it charged the steel material for each job at the market, when, in fact, as stipulated, the same was supplied in part out of its own stock on hand, which had cost it less than the market. Avoiding impasse, both parties naturally turned to inventory. There is no suggestion in the stipulation that the collector compelled recourse to inventory. The taxpayer and the assessor both use inventory. The dispute is about the kind of inventory valuations that the taxpayer sets up. On account of rising prices for steel in 1917, 1918, and 1919 valuation at the market of the steel inventory on hand at the end of each of those years figured out a considerable gain which went into the assessment for income tax. After the fall of prices in 1920 the taxapyer benefited by corresponding reduction of its assessment and tax. It has undoubtedly paid tax on some gains which it did not liquidate into cash money, just as it got credit later on for a loss not actually paid out of pocket. But that is no ground to cancel the tax. That is what recourse to inventory for income-tax assessment means. The
62 taxpayer has not taken his gains in money. They are in his inventory, and the collector has to go there to find and assess them. I cannot see how this taxpayer stands in any different case than thousands of others whose inventory values rose and fell in the period. Many who were entitled to it got relief under the inventory loss abatement provisions of sections 214 (a) (12) and 234 (a) (14) of the revenue act of 1918. The matter of such rebate for appellant was considered by the Board of Tax Appeals, and it was denied after hearing and no appeal is prosecuted. Its valuation plan for its steel inventory wipes out all income from inventory gains and avoids the tax altogether, and so avoids all tax much more effectually than the mere abatement for loss contemplated and provided for by Congress. But its plan, as I see it, is nothing more nor less than the old minimum-inventory method, which does not conform to the best accounting practice in trade or business, this for the obvious reason that it conceals the profits and loss of the business and so defeats the object of keeping books. It arbitrarily picks out a time, December 31, 1916, when steel was at a certain price and settles on the amount of steel that happened to be on hand at

that time and proposes to carry that amount at that same price through the ensuing years of price advance, and then upon the fall of price and the return to normal to resume inventory of all its steel at the market or cost, if lower. Thus it eliminates consideration in particular years and defeats any assessments therefor, and the tax goes with it. Of course the company made some money by keeping an adequate stock of steel on hand and using it on a constantly rising market. But its plan of inventory valuation conceals the fact and excludes the Government from any share. If it had held its steel in its piles during the period, there might be room for argument. But it did not.

The stipulation consists with the steel having been kept for about the same purpose and used in about the same way that stocks of raw material are ordinarily kept and used in many lines of business. The structural shapes and plates were produced in Pittsburg and used at remote points. A stock had to be, and was, kept on hand, not enough of course to fill all contracts but enough "to insure prompt and orderly execution of contracts in view of delay, etc., incident to shipments from the mills and other exigencies affecting the availability for use when needed of material ordered for a
63 particular job." There is no suggestion that the use was only when there was unusual or extraordinary delay of shipments, merely the "delay incident to shipment"—not a use confined to extraordinary "exigencies," merely the exigency that the job has to be done here and the mills are at Pittsburgh.

No stocks are carried on hand by merchants, manufacturers, or fabricants from choice. It is always done to insure orderly and prompt dispatch of business, necessitated because the production or accumulation of goods or materials is at one point and the business at another. Such considerations suggest no test for the tax collector. His test is whether there is a continued commingling in an indistinguishable mass and a productive use out of the mass in the business. If there is, and the gains of the business are included in the increased value of the mass, he must compare the changing values of it every fiscal year, and that is what he has done in this case. The taxpayer had to carry a stock of steel and use it in its business. It fell as low as fifteen hundred tons in 1912 and rose as high as eleven thousand tons in 1920, but fluctuated always in both quantity and value, and no cost price of any piece was ever to be distinguished in the mass. The collector rightly valued it at the market from year to year, assessed the increase, when there was any, with other gains, and made deductions at the slump for losses. To upset this action seems to me to invite chaos in the collection of the revenues.

I am not unmindful of the words "emergency use" in the stipulation applied to appellant's use of the steel which it proposes to

put in minimum inventory. I think the commissioner acceded to the use of the words "emergency use" in the stipulation as reflecting appellant's mental processes about it. They refer to the contractor's preference to handle the steel direct from the mill to the place of fabrication and to the job without double handling at its yards when feasible, perhaps even direct from the mills to the job; the stipulation is not clear. It also refers to the preference that the stock be kept up to a desirable point as near as feasible. But the words cannot have any other reference or significance in the face of the plain admission in the stipulation that production was remote from the jobs to be done, and the material had to be carried in stock and used to insure orderly execution of contracts. I
64 take it that the same preference to avoid double handling of heavy stuff and to keep stock up is general, and so all such stocks are for "emergency" use in that sense. I do not understand that the court concedes any more to counsel's arguments likening the use of steel from the pile to a borrowing from a neighbor than I do, nor to the arguments about which structural piece came from the top or the bottom of the pile, nor to the matter of what pieces may have stayed in the pile all through the history. These are simply attacks upon the recourse to any inventories by the tax collector. I understand it is not intended to strike down the acts and regulations concerning resort to inventory for income-tax assessments, but the court discerns in the case of this taxpayer a peculiar situation amounting to an exception. It is to that conclusion, that there is anything peculiar about this stock carried or the uses made of it or the reasons for carrying it, that I can not agree. It was necessary to carry it because the points of production, fabrication, and use were remote; it was replenished as are other stocks, not evenly but with such intermittency that the mass fluctuated constantly; on a rising market it gathered the gains of the business and on collapse its shrunken value reflected the loss. If this taxpayer can get its money back, so should thousands, because the use of inventories is practically universal. Nor can the Government in the future count with any security upon the taxes it collects in times of rising prices. A span of years may even them up again, and by this minimum-inventory system of accounting payments cheerfully made on gains well recognized at the time will be recovered by the shrewd and wary at the expense of the general.

The tax was laid and paid for the year 1918, when we had ten million men registered for war and millions in the field. The company ought not to get it back, nor for the year 1919 (dependent case No. 8359) either, when the men were coming back—mostly.

65 In United States Circuit Court of Appeals, Eighth Circuit

No. 8358

KANSAS CITY STRUCTURAL STEEL COMPANY, APPELLANT

vs.

COMMISSIONER OF INTERNAL REVENUE

On petition to review decision of United States Board of Tax Appeals

Decree

May 14, 1929

This cause came on to be heard on the transcript of the record from the United States Board of Tax Appeals for a review of a decision of said Board of Tax Appeals sustaining a deficiency assessment against the appellant in the sum of $7,656.74 and was argued by counsel.

On consideration whereof it is now here ordered, adjudged, and decreed by this court that the decision of the said Board of Tax Appeals be, and the same is hereby, reversed, without costs to either party in this court.

It is further ordered by this court that this cause be, and the same is hereby, remanded to the said Board of Tax Appeals.

May 14, 1929.

66 In United States Circuit Court of Appeals

Motion for stay of mandate

Filed June 13, 1929

Now comes the Commissioner of Internal Revenue, the respondent herein, by his attorney, C. M. Charest, general counsel, Bureau of Internal Revenue, and moves the court to enter an order herein staying its mandate for a period of three months from the date of the entry of judgment herein.

In support of this motion the said Commissioner of Internal Revenue respectfully shows to the court that he is considering the advisability of filing in the Supreme Court of the United States, within the three months' period provided by statute in that respect, a petition for certiorari to that court; that it is probable that such petition for certiorari will be filed; and that he believes it undesirable under such circumstances to have the mandate of this court issue in accordance with the general rules of the court.

C. M. CHAREST,
General Counsel, Bureau of Internal Revenue.
B. C.

67 In United States Circuit Court of Appeals

Order staying issuance of mandate

June 13, 1929

On consideration of the motion of appellee for a stay of the mandate in this cause for a period of three months from the date of the entry of decree in which to file a petition in the Supreme Court of the United States for a writ of certiorari, it is now here ordered by this court that the issuance of the mandate herein be, and the same is hereby, stayed for a period of ninety days from and after May 14, 1929, the date of the entry of decree of this court, and if within said period of ninety days there is filed with the clerk of this court a certificate of the clerk of the Supreme Court of the United States that a petition for writ of certiorari, record, and brief have been filed and proof by affidavit of notice thereof under paragraph 3 of rule 38 of the Supreme Court be given, the stay hereby granted shall continue until the final disposition of the case by the Supreme Court.

68–70 [Clerk's certificate to foregoing transcript omitted in printing.]

71 [Caption omitted.]

72 [Appearances of counsel omitted in printing.]

73 In United States Circuit Court of Appeals

Stipulation waiving printing of record, service of briefs, and for submission of cause on record and briefs in cause No. 8358

Filed Oct. 22, 1928

Whereas the questions of law involved in this case are identical with the questions of law involved in cause No. 8358, pending in this court, between the same parties, and whereas the facts are similar with the exception of certain amounts and the years involved,

Now therefore it is hereby stipulated by and between the parties, subject to the approval of the court, that the printing of the record herein and the printing and service of briefs herein may be waived and that this case may be submitted upon the record filed in cause No. 8358 and upon the briefs to be filed in said cause and that the

decision in cause No. 8358 shall control in this case, it being further stipulated that separate judgments and final orders of the Board of Tax Appeals shall be entered in the respective cases.

ARMWELL L. COOPER,
ELLISON A. NEEL,
WHITSON ROGERS,
Attorneys for Petitioner.
C. M. CHAREST,
General Counsel, Bureau of Internal Revenue.

74 [Appearance of counsel omitted in printing.]

In United States Circuit Court of Appeals

Order of submission

January 24, 1929

This cause having been called in its regular order, pursuant to the stipulation of counsel for the respective parties filed herein, the same is submitted to the court on the transcript of the record filed in case No. 8358, between the same parties, and upon the briefs of counsel filed in said cause.

In United States Circuit Court of Appeals

Note re opinion

The opinion of the United States Circuit Court of Appeals, majority and dissenting, filed in cause No. 8358, between the same parties, on May 14, 1929, and in pursuance of which the following decree was entered, is omitted from this transcript to avoid duplication, the same being set out in full in the transcript prepared in cause No. 8358 for filing with a petition for a writ of certiorari.

75 In United States Circuit Court of Appeals, Eighth Circuit

No. 8359

KANSAS CITY STRUCTURAL STEEL COMPANY, APPELLANT

vs.

COMMISSIONER OF INTERNAL REVENUE

On petition to review decision of United States Board of Tax Appeals

Decree

May 14, 1929

This cause came on to be heard, pursuant to stipulation of counsel for the respective parties, on the transcript of the record from the

United States Board of Tax Appeals in the case of Kansas City Structural Steel Company, appellant, vs. Commissioner of Internal Revenue, No. 8358, and the briefs of counsel filed in said cause.

On consideration whereof and in pursuance of said stipulation that the decision of this court in said cause No. 8358 shall control in this cause, and in accordance with the opinion of this court filed this day in said cause No. 8358, it is now here ordered, adjudged, and decreed by this court that the decision of the said Board of Tax Appeals in this cause be, and the same is hereby, reversed, without costs to either party in this court.

It is further ordered by this court that this cause be, and the same is hereby, remanded to the said Board of Tax Appeals.

May 14, 1929.

76 In United States Circuit Court of Appeals

Motion for stay of mandate

Filed June 13, 1929

Now comes the Commissioner of Internal Revenue, the respondent herein, by his attorney, C. M. Charest, general counsel, Bureau of Internal Revenue, and moves the court to enter an order herein staying its mandate for a period of three months from the date of the entry of judgment herein.

In support of this motion the said Commissioner of Internal Revenue respectfully shows to the court that he is considering the advisability of filing in the Supreme Court of the United States, within the three months' period provided by statute in that respect, a petition for certiorari to that court; that it is probable that such petition for certiorari will be filed; and that he believes it undesirable under such circumstances to have the mandate of this court issue in accordance with the general rules of the court.

C. M. CHAREST,
General Counsel, Bureau of Internal Revenue.

77 In United States Circuit Court of Appeals

Order staying issuance of mandate

June 13, 1929

On consideration of the motion of appellee for a stay of the mandate in this cause for a period of three months from the date of the entry of the decree in which to file a petition in the Supreme Court of the United States for a writ of certiorari, it is now here ordered by this court that the issuance of the mandate herein be, and the same is hereby, stayed for a period of ninety days from and after May 14, 1929, the date of the entry of decree of this court, and

within said period of ninety days there is filed with the clerk of this court a certificate of the clerk of the Supreme Court of the United States that a petition for writ of certiorari, record, and brief have been filed and proof by affidavit of notice thereof under paragraph 3 of rule 38 of the Supreme Court be given, the stay hereby granted shall continue until the final disposition of the case by the Supreme Court.

June 13, 1929.

[Clerk's certificate to foregoing transcript omitted in printing.]

Supreme Court of the United States

No. 323, October term, 1929

Order allowing certiorari

Filed October 21, 1929

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Eighth Circuit is granted. And it is further ordered that the duly certified copy of the transcript of the proceedings below, which accompanied the petition, shall be treated as though filed in response to such writ.

Supreme Court of the United States

No. 324, October term, 1929

Order allowing certiorari

Filed October 21, 1929

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Eighth Circuit is granted. And it is further ordered that the duly certified copy of the transcript of the proceedings below, which accompanied the petition, shall be treated as though filed in response to such writ.

[Indorsement on cover:] File Nos. 34454, 34455. U. S. Circuit Court of Appeals, Eighth Circuit. Term No. 323: Commissioner of Internal Revenue, petitioner, vs. Kansas City Structural Steel Company. Term No. 324: Commissioner of Internal Revenue, petitioner, vs. Kansas City Structural Steel Company. Petition for writs of certiorari and exhibits thereto. Filed August 14, 1929. File Nos. 34454, 34455.

U. S. GOVERNMENT PRINTING OFFICE: 1929

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Nos. 323 - 324

In the Supreme Court of the United States

OCTOBER TERM, 1929

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

KANSAS CITY STRUCTURAL STEEL COMPANY

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

KANSAS CITY STRUCTURAL STEEL COMPANY

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT AND BRIEF IN SUPPORT THEREOF

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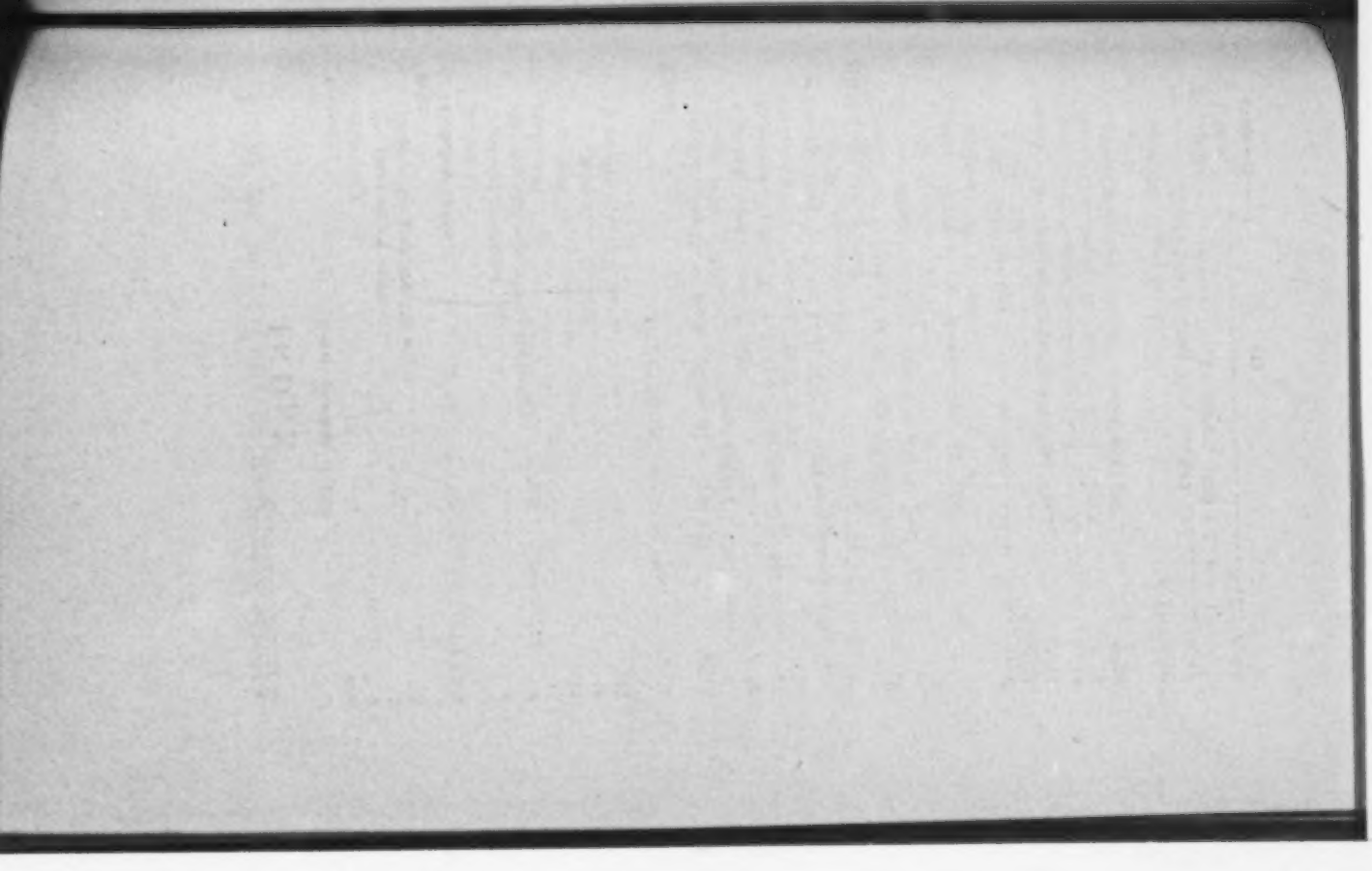

In the Supreme Court of the United States

OCTOBER TERM, 1929

No. ———

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

KANSAS CITY STRUCTURAL STEEL COMPANY

No. ———

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

KANSAS CITY STRUCTURAL STEEL COMPANY

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT AND BRIEF IN SUPPORT THEREOF

PETITION

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that writs of certiorari issue to review the judgments of the United States Circuit Court of Appeals for the Eighth Circuit entered in the above-entitled cases on May 14, 1929, reversing the decision of the United States Board of Tax Appeals.

STATEMENT

These cases involve income taxes for the years 1918 and 1920. (R. 33.) The taxpayer is a Missouri corporation and was engaged during the years in question in the business of fabricating and erecting structural steel plates for buildings, bridges, tanks, etc. Such business required the use of large quantities of steel bars, tank plates, and structural forms which the company purchased from steel mills. (R. 34–36.)

In order to insure the prompt and orderly execution of contracts, it was the practice of the taxpayer to maintain a considerable stock of material at its plant. (R. 34.) The amount of such stock recorded as being on hand at the end of each year was, roughly speaking, equal to from ¼ to ⅓ of the steel fabricated by the corporation during the entire year. (See tables, R. 35.) The exact quantity varied greatly by reason of the fact that the stock was being continually consumed and replenished in the course of production, in 1912 running as low as 1,500 tons and in 1920 exceeding at one time 11,000 tons. (R. 25, 33.)

As the steel from the reserve supply was used, it was replaced with material of a like kind and in a like quantity. (R. 34.) It does not appear, however, that any account was kept of the particular purchases composing the stock, or that the steel treated as constituting stock was the steel identifiable as to cost or date of acquisition.

In 1916 the price of structural steel was $1.70 per cwt., but beginning in that year the price advanced

until it reached $4.50 per cwt. for structural shapes and $9.45 per cwt. for tank plates. (R. 34.)

The taxpayer, in determining the amount of its taxable income for the years here in question, used inventories to compute the cost of the steel which it had consumed. (R. 34–35.) In such inventory computation, the taxpayer treated 5,554 tons, representing the amount of unfabricated steel held on hand at the close of the year 1916 as a reserve stock which it valued through the taxable years here involved at $1.70 per cwt. (R. 34.) It appears, however, that the total amount of the taxpayer's inventory dropped below the 5,554 tons during each year. All steel in excess of the 5,554 tons was inventoried at cost or market price, whichever was lower. (R. 35.)

The method used by taxpayer as to this 5,554 tons is known to accounting as the "base stock," "minimum," "cushion," or "constant average" method of inventory.

This method was employed by the taxpayer until December 31, 1921, when the price of steel had descended to $1.50 per cwt. The method was then abandoned and the entire inventory was valued by the taxpayer at cost or market, whichever was lower. (R. 34–35.)

The Commissioner of Internal Revenue, in auditing the taxpayer's income tax returns for 1918 and 1920, refused to approve the "base stock" plan which the taxpayer had employed in making its inventories, and to that extent rejected the inventory valuations

which the taxpayer had set up on its books. Since the steel comprising the stock could not be identified with particular invoices, the Commissioner, pursuant to Treasury regulations, computed its cost on the presumption that the supply on hand was that which had been most recently received, pricing the entire inventory at market. (R. 35.) This action resulted in tax deficiencies being determined for the years 1918 and 1920 in the amounts of $7,656.74 and $15,953.36, respectively.

The taxpayer appealed from such determination to the Board of Tax Appeals, but the Board approved the action of the Commissioner. (R. 39.) The taxpayer then filed petitions in the two cases here involved, seeking a review of the Board's decision by the United States Circuit Court of Appeals for the Eighth Circuit, and it was stipulated that the judgment in Case No. 8359 should follow the decision rendered in Case No. 8358.[1] In a decision rendered in the latter case, the Circuit Court of Appeals, by a divided bench, reversed the decision of the Board of Tax Appeals as it affected both cases (R. 49–59), holding that no taxable gains were realized upon 5,554 tons of steel, the amount which taxpayer treated as its reserve stock, and that to include it in inventory distorted rather than reflected the true income of the taxpayer.

[1] Record references given herein are from the record in Case No. 8358, unless otherwise specified.

SPECIFICATION OF ERRORS

The Circuit Court of Appeals erred:

1. In holding that inventories of the taxpayer's reserve stock of steel should not have been used in computing its income for the years in question.

2. In overruling the determination made by the Commissioner, pursuant to discretion vested in him by statute and under regulations of the Treasury Department, that inventories of the reserve stock were necessary properly to determine taxable income.

3. In holding that no taxable gain was realized by the taxpayer upon 5,554 tons of steel, the amount which taxpayer treated as its reserve stock.

REASONS FOR GRANTING THE WRITS

The tax amounts with which these cases are concerned are relatively small, but the principles of tax law involved are of general application and of serious importance to the Government. It is therefore desirable that the decision of the Circuit Court of Appeals be reviewed by this Court. The reasons for granting the writs are:

1. In the case of *Chicago Frog & Switch Co.* v. *United States*, decided by the Court of Claims on June 3, 1929, as yet unreported, it was held that a method of valuing inventories at the same arbitrary price from year to year, which would have the effect of carrying gains or losses of one year into succeeding years, was not sanctioned by the 1917 Act and the regulations thereunder. This principle, we submit, is equally applicable to the taxpayer's practice in the in-

stant case. Also in the case of *American Can Co.* v. *United States*, 31 F. (2d) 730, it was conceded by the taxpayer and assumed by the Circuit Court of Appeals for the Third Circuit that an inventory method quite comparable to the method adopted by the taxpayer herein was not reflective of true income. Petitions for writs of certiorari in that and subsidiary cases are now pending in this Court, but, in view of the above, no controversy is presented therein with respect to this question.

2. The conclusions of the Circuit Court of Appeals regarding the use of inventories which form the basis of the court's decision are not in accord with the best accounting practice. They are specifically in conflict with the principles approved in standard works on income-tax practice and are not sanctioned by recognized authorities on accounting. Montgomery on Income Tax Procedure, 1926 Ed., vol. 1, page 698; Foulke on The Federal Income Tax, Sec. 642.

3. The decision of the Circuit Court of Appeals is directly opposed to long administrative practice and the rules consistently applied by the Internal Revenue Bureau in the collection of revenue over a period of more than ten years. Advisory Tax Board Ruling 65 (see appendix, p. 17). It is also in conflict with regulations promulgated by the Treasury Department for use in connection with the Revenue Act of 1918, and with regulations promulgated for use in connection with the various other Revenue Acts since enacted. Art. 1582, Reg. 45, as amended by

T. D. 3296; Art. 1582, Reg. 62; Art. 1612, Reg. 65; Art. 1612, Reg. 69; Art. 102, Reg. 74.

4. The question involved is of far-reaching importance. Inventories are almost universally used where stocks of raw material are maintained for use in productive processes and they play a necessary part in the administration of the revenue laws. Confusion in administrative practice and discrimination in the treatment of taxpayers is almost certain to result unless the rules with regard to inventories are consistently applied. The matter is one, therefore, which should be settled finally by this Court.

Wherefore, it is respectfully submitted that this petition for writs of certiorari to review the judgments of the Circuit Court of Appeals for the Eighth Circuit should be granted.

CHARLES E. HUGHES, Jr.,
Solicitor General.

AUGUST, 1929.

65400—29——2

BRIEF IN SUPPORT OF PETITION

OPINIONS BELOW

The opinion of the United States Circuit Court of Appeals (R. 49) is reported in 33 F. (2d) 53. The opinion of the Board of Tax Appeals (R. 33) is reported in 11 B. T. A. 877.

JURISDICTION

The judgments of the Circuit Court of Appeals were entered May 14, 1929 (Case No. 8358, R. 59; Case No. 8359, R. 2), upon review of the decision of the Board of Tax Appeals, made pursuant to Sections 1001, 1002, and 1003 of the Revenue Act of 1926, c. 27, 44 Stat. 9, 109–110. (U. S. C. Supp. 1, Title 26, Secs. 1224–1226.) The jurisdiction of this Court to issue the writs is derived from Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Did the Commissioner of Internal Revenue in determining the income of the taxpayer corporation for the years in question properly require the taxpayer to inventory a supply of unfabricated steel denoted as an "emergency supply"?

2. Was the Commissioner correct in rejecting the "constant price" system of inventory valuation used by the taxpayer with respect to this "emergency supply" and in substituting therefor a "market price" valuation?

STATUTES AND REGULATIONS APPLICABLE

The pertinent provisions of the Revenue Act of 1918, c. 18, 40 Stat., 1057, 1060, are as follows:

> SEC. 203. That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

The pertinent provisions of Treasury Department Regulations 45 (1920 Edition, as amended by T. D. 3296), promulgated under the Revenue Act of 1918, are as follows:

> ART. 1581. *Need of inventories.*—In order to reflect the net income correctly, inventories at the beginning and end of each year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. The inventory should include raw materials and supplies on hand that have been acquired for sale, consumption, or use in productive processes, together with all finished or partly finished goods. * * *
>
> ART. 1582. *Valuation of inventories.*—The act provides two tests to which each inventory must conform: (1) It must conform as nearly as may be to the best accounting practice in the trade or business, and (2) it must clearly

reflect the income. * * * In order to clearly reflect income the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation, so long as the method or basis used is substantially in accord with the regulations. An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income.

The basis of valuation most commonly used by business concerns and which meets the requirements of the revenue act is (a) cost or (b) cost or market, whichever is lower.

* * * * *

* * * Goods taken in the inventory which have been so intermingled that they can not be identified with specific invoices will be deemed to be either (a) the goods most recently purchased or produced, and the cost thereof will be the actual cost of the goods purchased or produced during the period in which the quantity of goods in the inventory has been acquired, or (b) where the taxpayer maintains book inventories in accordance with a sound accounting system * * * the net value as shown by such inventory accounts will be deemed to be the cost of the goods on hand. * * *

* * * The inventories of taxpayers on whatever basis taken will be subject to investigation by the commissioner, and the tax-

payer must satisfy the commissioner of the correctness of the prices adopted.

The following methods, among others, are sometimes used in taking or valuing inventories, but are not in accord with these regulations, viz:

* * * * *

(d) Using a constant price or nominal value for a so-called normal quantity of materials or goods in stock.

[NOTE.—Art. 1582, *supra*, is in effect a restatement of a Treasury ruling promulgated in June, 1919, as Advisory Tax Board Ruling No. 65, appendix, p. 17.]

STATEMENT

A statement of the facts and an assignment of the errors relied on are set forth in the petition.

ARGUMENT

The substance of the opinion rendered by the Circuit Court of Appeals was that the taxpayer is a contractor; that the steel it used came direct for each job from the mills; that the actual cost of the steel consumed was the same as the cost of the steel ordered; and that the "emergency" stock remained, like its derricks and cranes, useful but unproductive of realized profits until entirely disposed of. Such conclusions can not properly be drawn from the facts found. This taxpayer is not a mere contractor, but a manufacturer who buys raw material in the form of plates and bars and fabricates it into the framework of bridges and buildings. The steel it used did not all come direct from the mills, but a

large part of it came from its own reserve supply. And the cost of such reserve supply steel was not equal to the cost of the steel ordered, for it had been acquired at an earlier date on a considerably lower market. The orders placed at the mills were not merely to take care of the particular job at hand, but also to replenish the reserve supply in preparation for anticipated future contracts.

The facts in this case, we submit, are therefore not unique; they are more or less typical of large numbers of other cases in which manufacturers maintain stocks of raw material for use in their productive processes. The stock here, like most other stocks, was kept in good faith; it was reasonable in amount; and it was necessitated by the remoteness of the more general supply. It was an "emergency" stock only in the sense that it was used to supply the immediate and somewhat temporary demands of the business. It fluctuated in amount from 1,500 tons to 11,000 tons (R. 25, 33). From this fluctuating reserve supply the taxpayer selected a constant of 5,554 tons which it set up on its inventory at a fixed valuation representing market value as of December 31, 1916. Yet so far as the actual content of this reserve stock was concerned it changed in character and varied in value from time to time. We submit that the court was in error in comparing a fluctuating stock of such nature to derricks and cranes, which remain unchanged and unproductive of income until finally disposed of.

The system of inventorying used by the taxpayer of valuing at the same price year after year a constant, so-called minimum quantity of material is not peculiar to this company. It is what is known to accounting practice as the "base stock" method. That method was carefully considered in the Advisory Tax Board Ruling No. 65 (appendix, p. 18) and disapproved as not truly reflecting income. This view was carried into the subsequent Treasury Regulations governing inventories to which later reference is made.

The purpose of the Government in this case, as in all cases where the "base stock" method has been disapproved, is not to tax paper profits but profits actually realized. It proposes to compute the cost of material actually used at its actual cost, and not at the cost of other material which would have been used had circumstances not prevented. The only practicable method of determining the cost of goods consumed from the reserve supply is by use of inventories, for records were not kept of the actual cost of the individual pieces of steel consumed and could not have been kept under any practicable system of accounting. Inventories served simply as a lumping method of determining such cost. By adding the cost of material on hand at the beginning of the year to the cost of material purchased, and then deducting the cost of material on hand at the end of the year, the cost of goods consumed could be determined. This inventory method is now used by the vast majority of business concerns which maintain fluctuating stocks of raw material for productive

use, and it is declared by recognized accountants to be in accord with the best accounting practice. Advisory Tax Board Ruling No. 65, *supra*; Montgomery, Income Tax Procedure, 1926 Ed., vol. 1, page 698; Foulke, The Federal Income Tax, Sec. 642.

Congress, in enacting the various Revenue Acts, recognized the necessity for inventories in the computation of income, and vested a broad discretion in the Commissioner to determine when they should be used. Congress also authorized the Secretary of the Treasury to prescribe rules and regulations regarding the method of making inventories. Pursuant to such authority rules were prepared and they have been published as Treasury Regulations for use in connection with all Revenue Acts since 1918. Art. 1582, Reg. 45, as amended by T. D. 3296; Art. 1582, Reg. 62; Art. 1612, Reg. 65; Art. 1612, Reg. 69; Art. 102, Reg. 74. Regulations so promulgated, if not in conflict with express statutory provisions, have the force and effect of law. *Maryland Casualty Co.* v. *United States*, 251 U. S. 342, 349; *United States* v. *Grimaud*, 220 U. S. 506. The regulations in regard to inventories have been approved by at least one court of appellate jurisdiction and by the United States Court of Claims. See *United States* v. *Kemp* (C. C. A., 5th), 12 F. (2d) 7, 9, certiorari denied, 273 U. S. 703, and *Chicago Frog & Switch Co.* v. *United States* (C. Cls.), unreported, decided June 3, 1929.

The decision of the Circuit Court of Appeals not only overruled the determinations made by the Commissioner in the exercise of his discretion but it

recognized doctrines and principles which are in direct conflict with the above Treasury Regulations.

Finally, the decision is inconsistent, in principle at least, with what authority there is on this question.

The disapproval by the Court of Claims in *Chicago Frog & Switch Co.* v. *United States, supra*, of an arbitrary method of valuing inventories which would have the effect of carrying gains or losses of one year into succeeding years would seem equally applicable to the taxpayer's practice in the instant case. The taxpayer in that case, because it was compelled to keep a substantial amount of rails on hand at all times, attempted to carry its inventory at a so-called base or standard price, which was the price at the beginning of the year, and it was not asserted that this price was either cost or market for the rails which were on hand at the close of the year. The Commissioner of Internal Revenue adjusted the inventory to market price and his action was approved by the court, which held that the law did not justify the practice of the taxpayer.

The decision here sanctions an inventory method of valuing reserve stock which was quite similar to the "constant inventory" system which was conceded not to be reflective of true income in the case of *American Can Co.* v. *United States*, 31 F. (2d) 730. In that case the taxpayer attempted to increase its opening inventory; here the attempt is to decrease the closing inventory. In each case the taxpayer has failed accurately to reflect the true cost of goods consumed.

CONCLUSION

The decision in the instant case represents a radical departure from long accepted administrative practice and interpretation. It is not of limited application, as the majority opinion suggests, for its facts are in no wise unique but are more or less typical of large numbers of other cases where reserve stocks are used in productive processes. The opinion of the dissenting judge, therefore, rightly apprehends that confusion may flow from the court's conclusions. For these, and other reasons previously urged, it is respectfully submitted that writs of certiorari should be issued.

CHARLES E. HUGHES, Jr.,
Solicitor General.

SEWALL KEY,
RANDOLPH C. SHAW,
Special Assistants to the Attorney General.

AUGUST, 1929.

APPENDIX

Advisory Tax Board Ruling No. 65

29–19–531.
T. B. R. 65.

Section 203, Article 1582: Valuation of inventories.

REVENUE ACTS OF 1917 AND 1918.—The base-stock method of taking inventories is not warranted by the law or the regulations.

The question is raised as to whether under the Revenue Acts of 1917 and 1918 the so-called "base stock," "minimum," or "cushion," hereinafter referred to as "base stock," method of taking inventories may be used.

Section 203 of the Revenue Act of 1918 provides as follows:

> That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

Article 1582 of Regulations 45 provides in part that:

> Inventories should be valued at (a) cost, or (b) cost or market, whichever is lower.

According to the base-stock method of taking inventories, a manufacturer or dealer values at the same price year after year the minimum quantity of goods which he must have on hand at all times. If this method is accepted as sound, a second question arises as to the method of determining this price. In the present case the closing inventory for the year 1916 was adopted as the minimum basis for quantity and unit of price, though there was some modification in the following year for new lines of goods.

Clearly the base-stock method of taking inventories is not within the terms of the regulations—that is, it is not such a basis as the Commissioner, with the approval of the Secretary, has prescribed. It remains to consider, however, whether such a method should be so prescribed "as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

The facts before the Advisory Tax Board do not warrant the conclusion that there has been any general adoption of the base-stock method of taking inventories as an "accounting practice," or that it has had any considerable recognition as the "best" accounting practice. On the contrary, it is certain that the method has not been widely adopted. The argument from usage is against rather than in favor of it. To sanction this method of inventorying in the case of the very small minority of taxpayers who have used it—some like the appellant, only for the last year or two—would work an unjustifiable discrimination against the great majority of the manufacturers and dealers who have not used it. Returns for 1918 must be made in accordance with the method of accounting regularly employed in keeping the books of the taxpayer, provided this method clearly reflects the income (sec. 212 (b)).

Probably more than 95 per cent of the manufacturers and dealers in this country—certainly a very large majority of them—keep their books in accordance with methods other than the base-stock method. Unequal and discriminative treatment of this kind is to be avoided whenever possible. The "best accounting practice" set up in section 203 as the guide or standard for the commissioner must be a practice which not only clearly reflects the income but which has been "regularly employed," presumably for a number of years, by a majority of the taxpayers involved. A procedure to become a "practice" must be widely used and must have withstood the changing tests of time. Practically none of these tests is met in the present appeal. In particular, the fact that so few business concerns use the base-stock method is strongly suggestive of the truth that it does not truly reflect the income.

That it is a truth appears as clearly upon analysis as upon an examination of trade practice. The present Federal income-tax system is based upon an annual accounting period. The object of an inventory is to assign to an annual accounting period its profits and losses. The effect of the base stock inventory method is to assign all profits and losses in respect of the minimum inventory to the year in which such inventory is liquidated. This result is accomplished through ignoring sales and exchanges of individual items of the inventory and treating the minimum inventory as a unit. Each sale or exchange of property for other property having a market value is, however, in fact a realization of taxable profit or deductible loss in the year in which it occurs and a method of accounting which disregards such realization does not truly reflect income.

Such profit is not, as suggested by counsel, unrealized appreciation. It is none the less taxable profit because immediately reinvested in inventory. (Moreover, such reinvestment is not an operating expense but, on the contrary, is an expenditure for working assets.) Similarly, loss so realized is none the less deductible loss even though the inventory is not reduced in quantity. In some cases highly conservative business concerns reckon *trading profits* by comparing current costs with current sales, disregarding basic inventory gains as quasi-capital gains; but even such concerns do not ordinarily disregard inventory losses. This makes it clear that the basic stock method is a mere counsel of conservatism which ignores quasi-capital gains from motives of prudence. We do not believe that profit from the sale of a basic or minimum inventory is ordinarily a capital gain, but whether it is or not such gains when arising in an annual accounting period by reason of transactions which, taken by themselves, constitute realizations of profit or loss can not be disregarded under American (as distinguished from British) income-tax laws.

To disregard them is to overstate or understate, as the case may be, profits for the annual accounting period. Where the base stock method is used it is true, as was stated in Advisory Tax Board Recommendation 48 with respect to the average cost inventory method that "in a business requiring goods to be carried for lengthy periods * * * this overstatement of profits will occur whenever the current market is declining, while on an advancing market the profits on the actual sales of the year will be understated." The Advisory Tax Board, therefore, concludes that the base stock inventory method does not "most clearly" reflect income.

For a more complete discussion of the subject of inventories see the Advisory Tax Board recommendation above referred to.

The fundamental theory underlying this method is unsound. While the taxpayer in question happened to adopt 1916 prices in introducing this method of inventorying, the usual practice and general object of the basic method is to get the base or constant stock at a figure below cost and hold it there. It arises not from a desire to measure capital and net income accurately but to play safe, stabilize profits, and provide reserves against possible future losses. It is a result of essentially the same policy and theory which lead bankers to write down their buildings to a nominal figure and to accumulate hidden reserves. These practices have never been allowed by income tax law and procedure in the case of banks. They can not be allowed in the case of manufacturers. Excessive conservatism in measuring or accounting for capital and income may be nearly as deleterious as the excessive optimism which in the past led some corporations to overstate profits. The latter leads to bankruptcy. The former leads to various evils and brings retributive penalties when occasion arises to measure capital (or "invested capital") for the purposes of rate making, profit, regulation, and the determination of excess-profits taxes.

The base stock inventory is suggested as a method of equalizing gains and losses over a period of abnormal price conditions. In substance it results in offsetting an inventory gain of one year against an inventory loss of another rather than in assigning to each year its true gain or loss. The fact that the revenue act of 1918 in its provisions with respect to inventory loss and net loss (sections 204, 214 (a) (12), 234 (a) (14), authorizes in some cases the carrying of a loss realized

in one year into accounts of another year is some indication that Congress did not intend that the ordinary inventory provisions should be construed to authorize such a transfer. Furthermore, the argument that the application of the ordinary rules as to inventories results in hardship is met by the fact that Congress has authorized relief against hardship through the medium of these inventory and net loss provisions in cases which are within the terms thereof.

The general importance of this subject makes it worthy of note that a distinguished British commission—the Committee on Financial Risks Attaching to the Holding of Trading Stocks—after a thorough investigation and analysis of this subject, decided against the base-stock method of inventorying in its report submitted December 5, 1918. (Cd. 9224, 1919.) "Accounting," the committee found in Great Britain, "with a few exceptions, consider that these practices (the base-stock method of inventorying and the practice among bankers of writing down buildings, accumulating secret reserves, etc.), misrepresent the facts. In good times large profits are made. If it is desirable to make reserves against the future, part of the profits realized should be set aside as reserves and so denominated. If goods have been bought for £50 and their market price has not fallen below £50 at the time of striking a balance, it is a misuse of language and a travesty of fact to write their value down to £20 out of profits made by selling something else.

"The correct procedure, it is maintained, is to place the difference of £30 to reserve." And again, referring to the fact that the British Board of Inland Revenue has felt compelled under court decisions to recognize the base-stock method in certain industries, the committee adds: "And it appears that in the absence of a statutory definition the Board of

Inland Revenue has felt itself unable to contest the base-stock system of valuation where it has prevailed. As the practice is repugnant to the views which Government and the majority of this committee hold as to the correct system of accounting, * * * this concession has not been extended beyond the point of obligation."

The reasons above stated lead to the conclusion that the base-stock method does not conform to the requirements of the Revenue Act of 1918. This conclusion does not, of course, preclude a taxpayer who values his inventory at cost and who retains identifiable goods year after year from attaining the result with respect to the identifiable goods so retained which would be attained through the use of the base-stock inventory method.

The general conclusion that the base-stock method does not conform to the requirements of the Revenue Act of 1918 applies to "goods taken in the inventory which have been so intermingled that they can not be identified with specific invoices." According to article 1582 of Regulations 45, such goods "will be deemed to be the goods most recently purchased." The warrant for this presumption or inference is that in the absence of evidence as to the actual fact in the specific case it is, as conceded by counsel for the taxpayer, more nearly true than any other. This presumption or inference is, therefore, not only warranted but required by the statute which in authorizing the Commissioner, with the approval of the Secretary, to prescribe a basis upon which inventories shall be taken requires him to prescribe such basis as "most clearly" reflects the income. Conversely, he can not properly prescribe that "goods taken in the inventory which have been so intermingled that they can not be identified with specific invoices" will be deemed to be the goods included in the minimum inventory.

It is suggested in behalf of the taxpayer that if the base-stock method is not approved, some alternative method should be prescribed other than the valuation of inventories as required by the present regulations at cost or market, whichever is lower. One method proposed is that inventories be valued on a moving average basis over a period of five years, more or less. According to this method one-fifth, for example, of the inventory would be deemed to be the goods most recently purchased, and the balance the goods on hand at the beginning of the year. Another method proposed is that the goods in the inventory be deemed to be the earliest rather than the latest purchases. These methods are open to the same objections as is the base-stock method. Inventories valued according to these methods would not as clearly reflect the income assignable to an accounting period as do inventories valued according to the present regulations.

Most of the reasoning above set forth with respect to the Revenue Act of 1918 applies to the Revenue Act of 1917. The Advisory Tax Board finds nothing in the earlier statute to warrant the use thereunder of methods of valuing inventories which can not be used under the later statute.

The Advisory Tax Board is of opinion, therefore, that neither the base stock method of taking inventories, nor the moving average method, nor a method based upon the presumption that goods in the inventory are the earliest purchases, is in conformity with the provisions of the Revenue Act of 1917 or of the Revenue Act of 1918, and recommends that no change be made in the present regulations with respect to the method of taking inventories.

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Nos. 323 and 324

In the Supreme Court of the United States

OCTOBER TERM, 1929

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

KANSAS CITY STRUCTURAL STEEL COMPANY

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

KANSAS CITY STRUCTURAL STEEL COMPANY

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE PETITIONER

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BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 20–26) is reported in 11 B. T. A. 877. That of the United States Circuit Court of Appeals for the Eighth Circuit (R. 31–42) is reported in 33 F. (2d) 53.

JURISDICTION

The judgments of the Circuit Court of Appeals were entered on May 14, 1929. (R. 43, 45.) The petition for writs of certiorari was granted October 21, 1929. (R. 47.) The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Did the Commissioner of Internal Revenue, in determining the income of the taxpayer corporation for the years in question, properly require the taxpayer to inventory a supply of unfabricated steel designated by it as an "emergency supply"?

2. Was the Commissioner correct in rejecting the "base stock" system of inventory valuation used by the taxpayer with respect to this so-called "emergency supply," and in substituting therefor a "market price" valuation?

STATUTE AND REGULATIONS APPLICABLE

The pertinent parts of the Revenue Act of 1918, c. 18, 40 Stat. 1057, 1060, 1065, 1077, are as follows:

> SEC. 232. * * * the term "net income" means the gross income * * * less the deductions allowed * * *.
>
> SEC. 213. * * * the term "gross income"—
>
> (a) Includes gains, profits, and income derived from * * * trades, businesses, commerce, or sales, or dealings in property,

whether real or personal, growing out of the ownership or use of or interest in such property; also from * * * the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

SEC. 203. That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

The pertinent provisions of Treasury Department Regulations 45 (1920 Edition, as amended by Treasury Decision 3296), promulgated under the Revenue Act of 1918, are as follows:

ART. 1581. *Need of inventories.*—In order to reflect the net income correctly, inventories at the beginning and end of each year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. The inventory should include raw materials and supplies on hand that have been acquired for sale, consumption, or use in productive processes, together with all finished or partly finished goods * * *.

ART. 1582. *Valuation of inventories.*—The act provides two tests to which each inven-

tory must conform: (1) It must conform as nearly as may be to the best accounting practice in the trade or business, and (2) it must clearly reflect the income. * * * In order to clearly reflect income the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation, so long as the method or basis used is substantially in accord with the regulations. An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income.

The basis of valuation most commonly used by business concerns and which meets the requirements of the revenue act is (*a*) cost or (*b*) cost or market, whichever is lower. * * *

* * * Goods taken in the inventory which have been so intermingled that they can not be identified with specific invoices will be deemed to be either (*a*) the goods most recently purchased or produced, and the cost thereof will be the actual cost of the goods purchased or produced during the period in which the quantity of goods in the inventory has been acquired, or (*b*) where the taxpayer maintains book inventories in accordance with a sound accounting system * * * the net value as shown by

such inventory accounts will be deemed to be the cost of the goods on hand. * * * * * * The inventories of taxpayers on whatever basis taken will be subject to investigation by the commissioner, and the taxpayer must satisfy the commissioner of the correctness of the prices adopted.

The following methods, among others, are sometimes used in taking or valuing inventories, but are not in accord with these regulations, viz:

* * * * *

(*d*) Using a constant price or nominal value for a so-called normal quantity of materials or goods in stock.

(NOTE.—The above provision relative to the valuing of inventories at a constant price is in effect a restatement of a Treasury ruling promulgated in *September,* 1919, as Advisory Tax Board Ruling No. 65, appendix, p. 27.)

STATEMENT

These cases involve income and profits taxes for the years 1918 and 1920. (R. 20.) The facts in both cases so far as they affect any question here are identical except for the differences in the years and the amounts of tax involved. (R. 44.)

The taxpayer is a Missouri corporation which was engaged, during the years in question, in the business of fabricating and erecting structural steel plates for buildings, bridges, tanks, etc. It used large quantities of steel bars, tank plates, and

structural forms which it procured, for the most part, directly from steel mills in accordance with the requirements of the particular job at hand. (R. 18, 20–21.)

In order to insure the prompt and orderly execution of its contracts it was the practice of the taxpayer to maintain a considerable stock of unfabricated steel at its plant. (R. 20–21.)

The amount of such stock recorded as being on hand at the end of each year was, roughly speaking, equal to from one-fourth to one-fifth of the steel fabricated by the taxpayer during the entire year. (See Tables, R. 21–22.) However, the exact quantity on hand at any one time varied greatly because the stock was being consumed and replenished continually in the course of production. In 1912 the stock ran as low as 1,500 tons and in 1920 it at one time exceeded 11,000 tons. See chart immediately following R. 18 marked "Exhibit A," which was made a part of the facts stipulated. (R. 16–18, 20.)

When steel was used from the taxpayer's stock it was promptly replaced with material of a like kind in a like quantity. (R. 21.) It does not appear, however, that any account was kept of the particular purchases composing the stock, or that any portion of the stock was identifiable either as to cost or date of acquisition. (R. 25.)

In 1916 the price of structural steel, such as that composing the taxpayer's stock, was $1.70 per cwt., f. o. b. Pittsburgh. The price then advanced

rapidly until July, 1917, when it reached $4.50 per cwt. for structural shapes and $9.45 per cwt. for tank plates. (R. 19, 21.) In September, 1917, the Government fixed the price of structural shapes at $3 per cwt. and that of tank plates at $3.25 per cwt., f. o. b. Pittsburgh. At the close of 1918 Government control was released and the price then gradually declined until 1921, when it reached $1.50 per cwt. for both structural forms and tank plates. (R. 21.) During the years here in question the prices were as follows (R. 19):

	1918	1920
Structural shapes	$3.00	$3.25-$2.45
Tank plates	3.25	3.75-2.65

The taxpayer, in determining the amount of its taxable income for the years 1918 and 1920, used inventories to compute the cost of the steel which it had consumed during each of those years. (R. 17, 21.) The method followed was that which was used by the taxpayer from 1916 to 1921, whereby at the close of each year it valued its inventory by considering 5,554 tons of unfabricated steel (an arbitrary amount equal to its 1916 closing inventory) as constituting a fixed stock or minimum inventory and this amount was priced at $1.70 per cwt. f. o. b. Pittsburgh (an arbitrary price equal to the cost of steel at the close of 1916). The balance of its stock, in excess of 5,554 tons, it valued at cost or market, whichever was lower. (R. 21.) The tonnage in stock during most of the years

1918 and 1919 was actually considerably less than 5,554 tons; during most of 1920 it was considerably above that amount. (See chart following R. 18.)

This method of valuing its inventory was employed by the taxpayer until December 31, 1921, when the price of steel had declined to $1.50 per cwt. The method was then abandoned and the entire inventory was valued by the taxpayer at cost or market, whichever was lower. (R. 21, 22.)

The Commissioner of Internal Revenue, in auditing the tax returns of the taxpayer for the years in question, accepted the tonnages shown in its inventories, but refused to accept the inventory valuations of the 5,554 tons as computed by the taxpayer's method. Since the steel composing the stock had been so intermingled that its cost could not be determined by identifying individual items with specific invoices, the Commissioner, in accordance with Treasury Regulations, computed its cost on the presumption that the steel on hand was that which had been most recently received. (R. 17, 22.) He valued at "market" the entire tonnage shown in the inventories, and thus increased both the opening and closing inventory valuations, as follows (R. 21):

Date	Per company	Per commissioner	Increase
Dec. 31, 1917	$271,827.87	$402,688.55	$130,860.68
Dec. 31, 1918	446,984.06	612,833.52	165,849.46
Dec. 31, 1919	449,976.69	562,992.28	113,015.59
Dec. 31, 1920	319,189.26	436,302.87	117,113.61

Such action of the Commissioner resulted in tax deficiencies being determined for the years 1918 and 1920 in the amounts of $7,656.74 and $15,953.36, respectively.

The taxpayer appealed from such determinations to the Board of Tax Appeals, but the Board approved the determinations of the Commissioner. (R. 25.) The taxpayer then filed a petition for review in each of its cases, seeking a review of the Board's decision by the United States Circuit Court of Appeals for the Eighth Circuit; and it was stipulated that the judgment entered in the case involving the year 1918 should control the case involving the year 1920. The Circuit Court of Appeals, by a divided bench, reversed the decision of the Board of Tax Appeals. (R. 31–42, 43, 45–46.) Writs of certiorari to the Circuit Court of Appeals have been issued by this Court. (R. 47.)

SPECIFICATION OF ERRORS

The Circuit Court of Appeals erred—

1. In holding that inventories of the taxpayer's reserve stock of steel should not have been used in computing its income for the years in question.

2. In overruling the determination made by the Commissioner, pursuant to discretion vested in him by statute and under regulations of the Treasury Department, that inventories of the reserve stock were necessary properly to determine taxable income.

3. In holding that no taxable gain was realized by the taxpayer upon 5,554 tons of steel, the amount which taxpayer treated as its reserve stock.

SUMMARY OF ARGUMENT

By the use of low-cost steel in productive processes during years of a rising steel market, taxpayer derived gains which its method of inventorying did not reflect. The Commissioner of Internal Revenue was justified in disapproving taxpayer's method of valuing at a constant cost an arbitrary amount of its reserve stock, for there was no actual segregation of such an amount, but all steel held in reserve was commingled in an indistinguishable mass from which continual withdrawals were made for productive purposes. The reserve stock drawn upon for production frequently contained steel of varying cost which could not be identified with specific invoices, and hence the cost of the steel consumed could be determined only by resort to inventories. The facts here do not warrant a conclusion that the business of the taxpayer constituted any exception to the statutory requirement for the use of inventories. In these cases the Commissioner of Internal Revenue, exercising discretion vested in him by statute, held that inventories were necessary to a proper determination of taxpayer's income. That determination should not be disturbed.

The taxpayer itself used inventories in computing its income but it valued those inventories by a "base stock" or "constant price" method which

the Commissioner refused to approve. The "base stock" method does not truly reflect income; it is not in accord with the best accounting practice; and it is expressly disapproved in regulations of the Treasury Department which have been consistently applied for more than ten years in the collection of the revenue. The courts also have refused to sanction such method of valuation.

The taxpayer in this case did not consistently use the "base stock" method but applied it only in the years of rising prices. It has failed to prove that such method was in accord with the best accounting practice in its trade or business. The Commissioner, on the other hand, has determined that the taxpayer's method of valuation was not in accord with the best accounting practice in the trade or business, and has found that the method did not truly reflect income. His determinations are *prima facie* correct, and, in the absence of any competent evidence to the contrary, they should be approved.

ARGUMENT

I

INVENTORIES OF THE TAXPAYER'S STOCK OF UNFABRICATED STEEL WERE NECESSARY TO A PROPER DETERMINATION OF ITS INCOME

The decision of the Circuit Court of Appeals in the instant cases holds in substance that the action of the Commissioner of Internal Revenue in requiring the taxpayer to include a stand-by or

"emergency" stock of unfabricated steel in its general inventory had the effect of distorting rather than reflecting income. The majority opinion below is based upon the conclusion that the taxpayer's business was not one requiring the use of inventories in the determination of income, and that its stand-by stock was equivalent to fixed equipment such as "cranes and derricks" (R. 38–39); was not "liquidated" and produced no income. It was, therefore, held that it was proper for the taxpayer to carry the stock at a constant valuation over the years here in question.

The Government here contends that by the use in productive process of low cost steel from its general reserve stock during years of a rising steel market the taxpayer made taxable gains which were disclosed only by the inventory method required by the Commissioner. It is also contended that the constant price valuation followed by the taxpayer was in reality nothing more than the "minimum" or "base stock" method of inventory, which is neither sanctioned by good accounting practice nor by the regulations of the Department.

It is submitted that from the facts found the court below erred in regarding the so-called "emergency stock" arbitrarily set by the taxpayer at 5,554 tons as the equivalent of fixed equipment and as "unliquidated" through the years in question. During the period that the taxpayer carried 5,554 tons at a constant inventory valuation there was never any actual segregation of such an amount,

but all steel held in reserve was commingled in an indistinguishable mass from which continual withdrawals were made for productive purposes. (R. 20–22, 25.) Such withdrawals frequently reduced the total stock on hand below 5,554 tons and during the greater part of the years 1918 and 1919 the stock remained below that figure. In fact, in 1919 it had receded to between 2,000 and 3,000 tons. (See Exhibit A inserted after R. 18.) Also, in 1917 and 1921 there were not 5,554 tons on hand when the closing inventories were reported. (R. 21.)

While it is indicated in the opinion of the Board of Tax Appeals that "some undeterminable part of the steel on hand in 1916 remained during the taxable years" (R. 24), the taxpayer had the burden of showing the cost of goods on hand, and in the absence of identification of a definite amount the stock on hand must be considered to be that most recently purchased. See Article 1582, Regulations 45, *supra*. It is clear that the greater part of the original 5,554 tons did not remain on hand throughout the period. The majority opinion below was, therefore, not correct in treating the reserve stock as remaining "intact" (R. 38) or in comparing it with fixed equipment such as "cranes and derricks." (R. 39.)

Considering all the facts, it seems clearly to be "of the substance" that the steel used in production from the reserve stock was converted and sold for a price higher than its cost with the resultant

taxable gain. Such profit is no more a "paper one" than would be the gain derived from the sale of a derrick for a price above that of its cost, even if the amount received from the sale should immediately be reinvested in another derrick.

While it is true, as the majority opinion below states (R. 33), that the taxpayer had 5,554 tons of the *same sort* of steel on hand December 31, 1921, as it did on December 31, 1916, the fact remains that, except for some portion not determinable and presumably small, the 1921 reserve steel *was not the same steel* as that of 1916.

Merchants and manufacturers generally maintain reserve stocks which are replenished regularly, and the fact that a similar quantity of raw materials is held throughout does not justify the conclusion that income is not derived from the use of such stock. The test for the tax collector, as the minority opinion suggests (R. 41), is whether there is a continued commingling in an indistinguishable mass and a productive use out of the mass in the business. If so, inventories are required to determine profit or loss. It does not constitute an exception to this rule that the finished stock is not held for any time nor that contracts are entered into prior to production. It is also immaterial what descriptive term be applied to the business, although we submit here that the fabrication of steel is essentially a manufacturing process.

Furthermore, the facts do not justify the conclusion that the reserve stock of the taxpayer was any

different in substance from the stocks of raw materials maintained by manufacturers who admittedly must inventory them. As is generally the case with such stock, that of the taxpayer was kept in good faith; its maintenance was made necessary by the remoteness of the more general supply; and its amount was as small as the demands of uninterrupted production would permit. It was an "emergency" stock only in the sense that it was used to supply the immediate and somewhat temporary needs of business. It was in a state of constant turnover; its amount fluctuated from approximately 1,500 tons to 11,000 tons (See Exhibit A, R. 18–19); and both new and old stock were so intermingled that specific items could not be identified either as to actual cost or date of acquisition.

In order to determine the taxpayer's true income for the years in question it was necessary to determine the cost of the steel which it actually used, as distinguished from that which it had ordered and would have used had not circumstances prevented. The part of the steel used which came direct from the mills could possibly be identified with specific invoices and its cost determined accordingly; but the steel withdrawn from stock could not be so identified and hence its cost could be determined only by resort to inventories. Such inventories, like all inventories, served merely as a lumping method of determining cost. By adding the inventory of the material on hand at the be-

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ginning of the year to the cost of the material purchased during the year, and then deducting from the total the inventory of the material remaining on hand at the close of the year, the cost of the material consumed could be determined. It is, in fact, the only way by which costs and income can be determined where there is a continued commingling of materials in an unidentifiable mass and production therefrom.

Regulations promulgated by the Treasury Department relative to the various Revenue Acts specifically provide for the use of inventories whenever such stocks are maintained for production purposes. Treasury Regulations 45, *supra*, states:

> ART. 1581. In order to reflect the net income correctly, inventories at the beginning and end of each year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. The inventory should include raw materials and supplies on hand that have been acquired for sale, consumption, or use in productive processes * * *.

Such regulations, if addressed to and reasonably adapted to the enforcement of an Act of Congress, have the force and effect of law when not in conflict with express statutory provisions. *Maryland Casualty Co.* v. *United States,* 251 U. S. 342, 349; *United States* v. *Grimaud,* 220 U. S. 506; *Bellefield* v. *Heiner* (C. C. A. 3d), 25 F. (2d) 560. The regulations of the Treasury Department relative to

inventories have been approved by both the Circuit Court of Appeals for the Fifth Circuit and the United States Court of Claims. *United States* v. *Kemp,* 12 F. (2d) 7, 9, certiorari denied, 273 U. S. 703; *Chicago Frog & Switch Co.* v. *United States,* unreported, decided by the Court of Claims June 3, 1929.

Inventories are now almost universally used by business concerns which maintain fluctuating stocks of raw material, and their use is regarded by accountants to be in accord with the best business practice. Foulke, The Federal Income Tax, Sec. 642 (quoted in the court's opinion in this case), says:

> Inventories are necessary in those cases where owing to the quantity of goods or commodities involved in the transaction it is not practicable to keep a separate account of each piece. An inventory is simply a lumping method of determining the gain or loss on the conversion of property in quantities where there is a fluctuation from year to year of the amount on hand, with a practical impossibility of separately itemizing the articles which are added or taken away.

Montgomery, Income Tax Procedure, 1926 Edition, Volume I, page 698, says:

> When a concern maintains a stock of any kind of property which is periodically renewed as it becomes exhausted, the proper procedure in determining profit or loss is to inventory the stock. * * *

Congress, in enacting the various Revenue Acts, recognized the necessity for inventories in the determination of income, but realized the difficulty of making any fixed rules as to when they should be used. It therefore placed a broad discretion in the Commissioner of Internal Revenue. The Revenue Act of 1918 (*supra*) provides:

> SEC. 203. That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

In this case the Commissioner determined that inventories were necessary to a clear determination of the taxpayer's income. The taxpayer had itself used inventories through all the years referred to in the record, and subsequently to December 31, 1921, when prices had become normal, inventoried all its stock at cost or market, whichever was lower, (R. 22.)

In consideration of the foregoing and in the absence of any evidence that the Commissioner abused the discretion vested in him by statute, it is submitted that the decision which he made in the exercise of that discretion should not be disturbed. *Williamsport Co.* v. *United States,* 277 U. S. 551; *Bates & Guild Co.* v. *Payne,* 194 U. S. 106, 108–110.

II

THE "BASE STOCK" METHOD OF INVENTORY VALUATION EMPLOYED BY THE TAXPAYER IS NOT IN ACCORD WITH THE BEST ACCOUNTING PRACTICE AND DOES NOT TRULY REFLECT INCOME

The majority opinion in the court below by the references (R. 34, 39) to the so-called "minimum" inventory system (which is more generally referred to as the "base stock" method) apparently concedes that such a method of valuing reserve stocks would not be sanctioned if adopted by merchants or manufacturers. It is the court's conclusion, however, that the taxpayer here does not fall within such a category and that its method of treating the reserve stock is not open to objection from an income tax standpoint.

It has previously been shown that the business of the taxpayer is essentially of a nature requiring recourse to inventories if income is clearly to be reflected and that the Commissioner had so determined. There remains for discussion whether or not the inventory method followed by the taxpayer with respect to its reserve stock was correctly changed by the Commissioner.

During the years of suddenly advancing steel prices the taxpayer treated its inventory as though divided in two parts: (1) the "minimum" or "base" inventory which it arbitrarily set at 5,554 tons and which it arbitrarily valued at $1.70 per cwt., and (2) the inventory in excess of 5,554 tons, which it valued at cost or market, whichever was

lower. The "minimum" inventory is regarded as a nonfluctuating, nonchanging unit. It ignored the fact that the specific items composing it were in fact gradually consumed on a high-priced market, and that the new steel, procured to keep up the stock, was actually obtained at a considerable increase in cost. It valued this "minimum" inventory as though the steel which originally composed it always remained in stock, and thus from year to year it set up on its books the constant valuation of $1.70 per cwt.

The system followed is known to accounting as the "base stock," "minimum," or "cushion" method, and will hereinafter be referred to as the "base stock" method. Such method of valuation is fundamentally unsound in that it does not truly reflect income. In years of rising prices it causes an understatement of income, for it disregards the gains actually realized through liquidation of low-priced stock on a high-priced market. In times of falling prices it causes an overstatement of income, for it ignores the losses which result when the high-priced stock is consumed. It substitutes an arbitrary bookkeeping figure for the true cost of the materials which compose the stock, sets up a false valuation for the stock account, and prevents a true reflection of the taxpayer's financial position in any balance sheet in which the valuations are used.

The "base stock" method also prevents the recognition of gains and losses in the proper taxable years. By ignoring the stock turnover it balances

the gains realized in one year against the losses sustained in another year and prohibits the recognition of any such gains or losses until the year in which the entire inventory is finally liquidated. This is at variance with the Federal income tax system, which is based upon an annual accounting period and requires that gains or losses be accounted for in the years when realized. This requirement was not met in the method followed by the taxpayer with respect to its reserve stock, and hence such method was properly disapproved by the Commissioner.

Moreover, the "base stock" method of inventory valuation is not in accord with the best accounting practice; it is not widely used by business organizations; and it is in conflict with regulations which the Treasury Department has applied for more than ten years in the collection of the revenue. Shortly after the enactment of the Revenue Act of 1918 the Advisory Tax Board, created by that Act for the special purpose of assisting in the interpretation and administration of the revenue laws, undertook an exhaustive study of the "base stock" method of inventory, and its conclusions were published by the Treasury Department in June, 1919, as Tax Board Ruling 65, 1 C. B. 51. (See appendix to this brief.) Excerpts from those conclusions are as follows (p. 52):

> The facts before the Advisory Tax Board do not warrant the conclusion that there has

been any general adoption of the base-stock method of taking inventories as an "accounting practice," or that it has had any considerable recognition as the "best" accounting practice. On the contrary, it is certain that the method has not been widely adopted. The argument from usage is against rather than in favor of it. To sanction this method of inventorying in the case of the very small minority of taxpayers who have used it—some like the appellant, only for the last year or two—would work an unjustifiable discrimination against the great majority of manufacturers and dealers who have not used it. * * * Probably more than 95 per cent of the manufacturers and dealers in this country—certainly a very large majority of them—keep their books in accordance with methods other than the base-stock method. Unequal and discriminative treatment of this kind is to be avoided whenever possible. The "best accounting practice" set up in section 203 as the guide or standard for the commissioner must be a practice which not only clearly reflects the income but which has been "regularly employed," presumably for a number of years, by a majority of the taxpayers involved. A procedure to become a "practice" must be widely used and must have withstood the changing tests of time. Practically none of these tests is met in the present appeal. In particular, the fact that so few business concerns use the base-stock method is strongly

suggestive of the truth that it does not truly reflect the income.

Following the publication of the Advisory Tax Board ruling, the Regulations of the Treasury Department were amended so as to expressly disapprove "using a constant price or nominal value for a so-called normal quantity of materials or goods in stock" (Article 1582, Regulations 45, *supra*); and a similar disapproval has been incorporated in the Regulations for all Revenue Acts since enacted (Article 1582, Regulations 62, relative to the Revenue Act of 1921; Article 1612, Regulations 65, relative to the Revenue Act of 1924; Article 1612, Regulations 69, relative to the Revenue Act of 1926; and Article 102, Regulations 74, relative to the Revenue Act of 1928). Montgomery, Income Tax Procedure, 1926 Edition, Vol. I, p. 712, in commenting upon the provision in the Regulations disapproving, among others, the "base stock" method, says:

> The foregoing regulation is an admirable exposition of good accounting practice. * * *
>
> The five methods which are specifically disapproved are in themselves technical departures from good accounting practice.

The courts, also, have refused to sanction the use of the "base stock" inventory. In *Chicago Frog & Switch Co.* v. *United States, supra,* the taxpayer found it necessary to maintain on hand at all times

a substantial amount of rails. It therefore attempted to carry its inventory at a so-called base or standard price, which was the price at the beginning of the year, and it was not asserted that this price was either cost or market for the rails. The Commissioner of Internal Revenue adjusted the inventory to market price and his action was approved by the Court of Claims.

In *American Can Co.* v. *United States,* and associated cases (C. C. A. 3d), 31 F. (2d) 730, now pending in this Court on writs of certiorari, the taxpayer valued its stock of tin plate by a "constant inventory" system, which was very similar to the system used by the taxpayer in this case. There the taxpayer attempted to write up its opening inventory to a figure in excess of actual cost; here the taxpayer attempted to write down both its opening and closing inventories to a figure less than the actual cost. In both cases an arbitrary "base" figure was used and the true cost of the stock consumed was not reflected. Since the taxpayers in the above cases conceded that the "constant inventory" did not truly reflect income, and the court agreed that it did not, the review on certiorari does not involve the question here.

The Circuit Court of Appeals for the Second Circuit had occasion to consider the "constant inventory" system of the same taxpayer in the case of *American Can Co.* v. *Bowers,* 35 F. (2d) 832, and also agreed that the method did not properly reflect income.

Finally, it should be noted that the taxpayer in this case did not consistently use the "base stock" method of valuation from year to year, but abandoned it after the price of steel had fallen below $1.70. (R. 22.) It should also be noted that the taxpayer has failed to prove that such method of valuation was in accord with the best accounting practice in its trade or business. The Commissioner, on the other hand, has determined that it was not, and that the method followed did not truly reflect income. His determinations are *prima facie* correct. *Wickwire* v. *Reinecke,* 275 U. S. 101; *Reinecke* v. *Spalding,* 280 U. S. 227; *Brown* v. *Commissioner* (C. C. A. 5th), 22 F. (2d) 797; *Bishoff* v. *Commissioner* (C. C. A. 3d), 27 F. (2d) 91; *Avery* v. *Commissioner of Internal Revenue* (C. C. A. 5th), 22 F. (2d) 6. The Commissioner's determinations were approved by the Board of Tax Appeals, and it is believed that upon the record presented they should not have been disturbed.

CONCLUSION

We submit that the Circuit Court of Appeals for the Eighth Circuit has approved in these cases a method of valuing raw materials used in productive processes which does not reflect true income, which is not in accordance with the "best accounting practice in the trade or business," and which is at variance with the Regulations of the Treasury Department. Furthermore, the decision is inconsistent,

in principle at least, with what authority exists as to the question.

It is respectfully submitted that the judgment below should be reversed.

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FEBRUARY, 1930.

APPENDIX

ADVISORY TAX BOARD RULING No. 65

22–19–531.
T. B. R. 65.

Section 203, Article 1582: Valuation of inventories.

Revenue Acts of 1917 and 1918.—The base-stock method of taking inventories is not warranted by the law or the regulations.

The question is raised as to whether under the Revenue Act of 1917 and 1918 the so-called "base stock," "minimum," or "cushion," hereinafter referred to as "base stock," method of taking inventories may be used.

Section 203 of the Revenue Act of 1918 provides as follows:

> That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

Article 1582 of Regulations 45 provides in part that:

> Inventories should be valued at (a) cost, or (b) cost or market, whichever is lower.

According to the base-stock method of taking inventories a manufacturer or dealer values at the same price year after year the minimum quantity of goods which he must have on hand at all times. If this method is accepted as sound, a second question arises as to the method of determining this price. In the present case the closing inventory for the year 1916 was adopted as the minimum basis for quantity and unit of price, though there was some modification in the following year for new lines of goods.

Clearly the base-stock method of taking inventories is not within the terms of the regulations—that is, it is not such a basis as the Commissioner, with the approval of the Secretary, has prescribed. It remains to consider, however, whether such a method should be so prescribed "as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

The facts before the Advisory Tax Board do not warrant the conclusion that there has been any general adoption of the base-stock method of taking inventories as an accounting practice," or that it has had any considerable recognition as the "best" accounting practice. On the contrary, it is certain that the method has not been widely adopted. The argument from usage is against rather than in favor of it. To sanction this method of inventorying in the case of the very small minority of taxpayers who have used it—some like the appellant, only for the last year or two—would work an unjustifiable discrimination against the great majority of the manufacturers and dealers who have not used it. Returns for 1918 must be made in accord-

ance with the method of accounting regularly employed in keeping the books of the taxpayer, provided this method clearly reflects the income (sec. 212 (b)). Probably more than 95 per cent of the manufacturers and dealers in this country—certainly a very large majority of them—keep their books in accordance with methods other than the base-stock method. Unequal and discriminative treatment of this kind is to be avoided whenever possible. The "best accounting practice" set up in section 203 as the guide or standard for the commissioner must be a practice which not only clearly reflects the income but which has been "regularly employed," presumably for a number of years, by a majority of the taxpayers involved. A procedure to become a " practice" must be widely used and must have withstood the changing tests of time. Practically none of these tests is met in the present appeal. In particular, the fact that so few business concerns use the base-stock method is strongly suggestive of the truth that it does not truly reflect the income.

That it is a truth appears as clearly upon analysis as upon an examination of trade practice. The present Federal income-tax system is based upon an annual accounting period. The object of an inventory is to assign to an annual accounting period its profits and losses. The effect of the base stock inventory method is to assign all profits and losses in respect of the minimum inventory to the year in which such inventory is liquidated. This result is accomplished through ignoring sales and exchanges of individual items of the inventory and treating the minimum inventory as a unit. Each sale or exchange of property for other property

having a market value is, however, in fact a realization of taxable profit or deductible loss in the year in which it occurs and a method of accounting which disregards such realization does not truly reflect income. Such profit is not, as suggested by counsel, unrealized appreciation. It is none the less taxable profit because immediately reinvested in inventory. (Moreover, such reinvestment is not an operating expense but, on the contrary, is an expenditure for working assets.) Similarly, loss so realized is none the less deductible loss even though the inventory is not reduced in quantity. In some cases highly conservative business concerns reckon *trading profits* by comparing current costs with current sales, disregarding basic inventory gains as quasi-capital gains; but even such concerns do not ordinarily disregard inventory losses. This makes it clear that the basic stock method is a mere counsel of conservatism, which ignores quasi-capital gains from motives of prudence.

We do not believe that profit from the sale of a basic or minimum inventory is ordinarily a capital gain, but whether it is or not such gains when arising in an annual accounting period by reason of transactions which, taken by themselves, constitute realizations of profit or loss can not be disregarded under American (as distinguished from British) income tax laws. To disregard them is to overstate or understate, as the case may be, profits for the annual accounting period. Where the base stock method is used it is true, as was stated in Advisory Tax Board Recommendation 48 with respect to the average cost inventory method that "in a business requiring goods to be carried for lengthy

periods * * * this overstatement of profits will occur whenever the current market is declining, while on an advancing market the profits on the actual sales of the year will be understated." The Advisory Tax Board, therefore, concludes that the base stock inventory method does not "most clearly" reflect income. For a more complete discussion of the subject of inventories see the Advisory Tax Board recommendation above referred to.

The fundamental theory underlying this method is unsound. While the taxpayer in question happened to adopt 1916 prices in introducing this method of inventorying, the usual practice and general object of the basic method is to get the base or constant stock at a figure below cost and hold it there. It arises not from a desire to measure capital and net income accurately, but to play safe, stabilize profits, and provide reserves against possible future losses. It is a result of essentially the same policy and theory which lead bankers to write down their buildings to a nominal figure and to accumulate hidden reserves. These practices have never been allowed by income-tax law and procedure in the case of banks. They can not be allowed in the case of manufacturers. Excessive conservatism in measuring or accounting for capital and income may be nearly as deleterious as the excessive optimism which in the past led some corporations to overstate profits. The latter leads to bankruptcy. The former leads to various evils and brings retributive penalties when occasion arises to measure capital (or "invested capital") for the purposes of rate making, profit, regulation, and the determination of excess-profits taxes.

The base stock inventory is suggested as a method of equalizing gains and losses over a period of abnormal price conditions. In substance it results in offsetting an inventory gain of one year against an inventory loss of another rather than in assigning to each year its true gain or loss. The fact that the revenue act of 1918 in its provisions with respect to inventory loss and net loss (sections 204, 214 (a) (12), 234 (a) (14), authorizes in some cases the carrying of a loss realized in one year into accounts of another year is some indication that Congress did not intend that the ordinary inventory provisions should be construed to authorize such a transfer. Furthermore, the argument that the application of the ordinary rules as to inventories results in hardship is met by the fact that Congress has authorized relief against hardship through the medium of these inventory and net loss provisions in cases which are within the terms thereof.

The general importance of this subject makes it worthy of note that a distinguished British commission—the Committee on Financial Risks Attaching to the Holding of Trading Stocks—after a thorough investigation and analysis of this subject, decided against the base-stock method of inventorying in its report submitted December 5, 1918. (Cd. 9224, 1919.) "Accountants," the committee found in Great Britain, "with a few exceptions, consider that these practices (the base-stock method of inventorying and the practice among bankers of writing down buildings, accumulating secret reserves, etc.) misrepresent the facts. In good times large profits are made. If it is desirable to make reserves against the future, part of the profits realized should be set aside as reserves and so de-

nominated. If goods have been bought for £50 and their market price has not fallen below £50 at the time of striking a balance, it is a misuse of language and a travesty of fact to write their value down to £20 out of profits made by selling something else. The correct procedure, it is maintained, is to place the difference of £30 to reserve." And again, referring to the fact that the British Board of Inland Revenue has felt compelled under court decisions to recognize the base-stock method in certain industries, the committee adds: "And it appears that in the absence of a statutory definition the Board of Inland Revenue has felt itself unable to contest the base-stock system of valuation where it has prevailed. As the practice is repugnant to the views which Government and the majority of this committee hold as to the correct system of accounting, * * * this concession has not been extended beyond the point of obligation."

The reasons above stated lead to the conclusion that the base-stock method does not conform to the requirements of the Revenue Act of 1918. This conclusion does not, of course, preclude a taxpayer who values his inventory at cost and who retains identifiable goods year after year from attaining the result with respect to the identifiable goods so retained which would be attained through the use of the base-stock inventory method.

The general conclusion that the base-stock method does not conform to the requirements of the Revenue Act of 1918 applies to "goods taken in the inventory which have been so intermingled that they can not be identified with specific invoices." According to article 1582 of Regulations

45, such goods "will be deemed to be the goods most recently purchased." The warrant for this presumption or inference is that in the absence of evidence as to the actual fact in the specific case it is, as conceded by counsel for the taxpayer, more nearly true than any other. This presumption or inference is, therefore, not only warranted but required by the statute which in authorizing the Commissioner, with the approval of the Secretary, to prescribe a basis upon which inventories shall be taken requires him to prescribe such basis as "most clearly" reflects the income. Conversely, he can not properly prescribe that "goods taken in the inventory which have been so intermingled that they can not be identified with specific invoices" will be deemed to be the goods included in the minimum inventory.

It is suggested in behalf of the taxpayer that if the base stock method is not approved, some alternative method should be prescribed other than the valuation of inventories as required by the present regulations at cost or market, whichever is lower. One method proposed is that inventories be valued on a moving average basis over a period of five years, more or less. According to this method one-fifth, for example, of the inventory would be deemed to be the goods most recently purchased, and the balance the goods on hand at the beginning of the year. Another method proposed is that the goods in the inventory be deemed to be the earliest rather than the latest purchases. These methods are open to the same objections as is the base stock method. Inventories valued according to these methods would not as clearly reflect the income as-

signable to an accounting period as do inventories valued according to the present regulations.

Most of the reasoning above set forth with respect to the Revenue Act of 1918 applies to the Revenue Act of 1917. The Advisory Tax Board finds nothing in the earlier statute to warrant the use thereunder of methods of valuing inventories which can not be used under the later statute.

The Advisory Tax Board is of opinion, therefore, that neither the base-stock method of taking inventories, nor the moving average method, nor a method based upon the presumption that goods in the inventory are the earliest purchases, is in conformity with the provisions of the Revenue Act of 1917 or of the Revenue Act of 1918, and recommends that no change be made in the present regulations with respect to the method of taking inventories.

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Nos. 323, 324.

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1929.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

VS.

KANSAS CITY STRUCTURAL STEEL COMPANY.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

VS.

KANSAS CITY STRUCTURAL STEEL COMPANY.

BRIEF IN OPPOSITION TO PETITIONS FOR WRITS OF CERTIORARI.

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BRIEF IN OPPOSITION TO PETITIONS FOR WRITS OF CERTIORARI.

Statement.

A judgment of the United States Board of Tax Appeals was promulgated April 30, 1928, affirming, by a divided vote, the action or judgment of the Commissioner of Internal Revenue in assessing an additional or deficiency income tax against the taxpayer for the

years 1918 and 1920. The tax was made up of several items, but this case involves only the portion based upon an alleged gain in inventory, comprising 5554 tons of unfabricated structural steel and steel plates set aside and kept on hand for emergency use. The cases as to both years were tried and submitted upon an agreed statement of all the facts, which will be found at page 20 of the printed record. As this Stipulation of Facts amounts to a special verdict with which the judgment must be in harmony, we conceive it to be our proper duty to present the facts quite fully. The petitioner has filed but one brief in both cases and we will do likewise.

The taxpayer was engaged in the business of fabricating and erecting, by contract, structural steel and steel plates for buildings, bridges, tanks and other structures. It fabricated and erected such material for each specific structure and contract and carried no finished product in stock. Material was ordered and procured, at the then market price, from the rolling mills for each specific structure and contract. However, a supply of material was kept on hand for emergency use only (under the practice herein set out) to insure the prompt and orderly execution of contracts, in view of delays incident to shipments from the mills and other exigencies affecting the availability for use, when needed, of the material theretofore ordered and purchased for the particular and specific jobs. The uniform and consistently observed plan and practice was that when, in such emergencies, material was so used from such supply, it was charged to the contract at its re-

placement cost, and upon receipt of the like material previously purchased for the particular job upon which such emergency material was used, was promptly replaced with material of a like kind and in a like quantity. The taxpayer was not a merchant, dealer or manufacturer and such material was not for sale and did not constitute a merchandising stock. On the contrary, it was a contractor for the delivery of the completed structure in place, involving and embracing all labor and material. The emergency material was very heavy and was kept in convenient piles of like kind. When such material was so used it was taken from the top of the pile (the Commisioner of Internal Revenue assumed it was taken from the bottom) and the replacement material was put on top of the pile from which the used material was taken or borrowed. The amount of such material on hand on December 31, 1916, was 5554 tons, which the taxpayer set aside and substantially maintained for such emergency use (and not otherwise) under the practice aforesaid, and carried it at its cost of $1.70 per hundredweight f. o. b. Pittsburgh, Pa., or, with freight added, at $2.136 per hundredweight f. o. b. Kansas City, Missouri. An alleged gain in inventory of this material forms the basis of the tax in controversy, which is in addition to the tax upon the taxpayer's income derived from the normal conduct of its contracting business.

The taxpayer contends that no income did (nor could prior to final liquidation) accrue from such emergency material as a basis for the imposition of the tax complained of, whereas the Commissioner of In-

ternal Revenue priced the same at the end of the year at the cost of a corresponding quantity of the most recent purchase of similar material and assessed a tax upon an assumed income based upon the difference between the value thereof, as of December 31, 1917, and December 31, 1919, respectively, and the higher value thereof, as of December 31, 1918, and December 31, 1920, respectively. This resulted in a fictitious increase of the taxpayer's taxable income, and the additional or deficiency tax which is in controversy.

The Stipulation of Facts upon which the case was tried provides:

> "The company is engaged in the fabrication and erection of structural steel plates for buildings, bridges, tanks, etc. It fabricates material for specific structures or contracts and carries no finished product in stock. Material is ordered and procured from the mills for each specific structure or contract, except that a supply of material, as shown in Exhibit A, has been kept on hand for emergency use (from which material is borrowed and replaced) to insure the prompt and orderly execution of contracts in view of delay, etc., incident to shipments from the mills and other exigencies affecting the availability for use when needed of material ordered for a particular job. When such material is used it is charged to the contract at its replacement cost and is promptly replaced with material of a like kind and in a like quantity" (p. 21).

> "The company, at the end of the years 1916, 1917, 1918, 1919 and 1920, valued its said supply of 5554 tons at the cost price prevailing at the close of 1916, or $1.70 per hundredweight f. o. b. Pittsburgh" (p. 21).

"The Commissioner of Internal Revenue in pricing the inventory of the company has disregarded the said fixed quantity of 5554 tons assuming that the last purchases represented the entire inventory and using said last purchases as a basis for valuation" (p. 22).

BRIEF AND ARGUMENT.

The petitioner contends and bottoms his petitions for the writs upon the following:

(1) That the so-called "constant," "base" or "minimum" inventory principle is contended for by the taxpayer and was recognized and applied by the Circuit Court of Appeals;

(2) That the taxpayer is a manufacturer and not merely an ordinary building or construction contractor and that, therefore, the inventory statute and regulations applicable to dealers and manufacturers apply to the emergency material described in the Stipulation of Facts upon which the case was tried; and,

I.

As to the first proposition, that the Circuit Court of Appeals recognized and applied the so-called "constant," "base" or "minimum" inventory principle, it is only necessary to refer to the opinion wherein it is repeatedly asserted to the contrary.

In the majority opinion it is said (p. 52):

> "The Government urges that this is but another claim of the right to set up a 'minimum inventory' formerly but unsuccessfully claimed by retailers and dealers. If it is, then the appeal must fail; * * *."

In the minority opinion, it is said (pp. 58, 59):

> "I understand it is not intended to strike down the acts and regulations concerning resort to inventory for income tax assessments, but the court

discerns in the case of this taxpayer a peculiar situation amounting to an exception."

II.

As to the second proposition we submit that the taxpayer was a construction contractor and not a manufacturer or dealer; and the inventory statute and the departmental regulations made in pursuance thereof, were not applicable (under the agreed facts) to the 5554 tons of emergency material.

In the majority opinion of the Circuit Court of Appeals in this case, it is said (p. 53):

> "At the outset it should be remembered that a wide discretion is vested in the commissioner, and not in the courts; and if the business is one where there is any substantial evidence indicating the necessity for the use of inventories, his decision backed by majority opinion of the Board of Tax Appeals, should not be disturbed. On the other hand, if, under the agreed facts, a situation is presented where it is clear that the use of an inventory is not only not necessary, but as a matter of fact distorts rather than reflects income, then the appellant has a right to invoke the aid of the courts."

Under the principle announced in the case of *Eisner* v. *Macomber*, 252 U. S. 189, l. c. 206 (64 L. Ed. 521, l. c. 528), that:

> • • • "it becomes essential to distinguish between what is, and what is not, 'income' as the term is there used; and to apply the distinction as cases arise according to truth and substance without regard to form,"

t became the duty of the Circuit Court of Appeals to nalyze the Stipulation of Facts for the purpose of

determining, as a fact, whether or not the taxpayer derived any taxable income from the emergency material. This the Court did with great care and superb accuracy, treating the business activities of the taxpayer as they were, recognizing that income is the *sine qua non* of the tax and concluding that there was no income upon which the tax in controversy could be assessed.

It is obvious, from the opinion itself, that no rule of law was anounced by the Circuit Court of Appeals in conflict with any decision of this Court or of any other of the Courts of Appeals. What it did, and all it did, was, as stated, to analyze the true agreed facts and apply the settled law thereto, with the conclusion that inasmuch as there was no income, there could be no tax.

Moreover, it was the duty of the Circuit Court of Appeals to supplement (as this Court will do) the agreed facts with its judicial knowledge "of the general course of business and the usual methods of transacting it" (23 C. J. 62), and in connection therewith, to not close its "eyes to the well known course of business in the country" (*Bank of Kentucky* v. *Adams Express Company*, 93 U. S. 174, 185).

The Stipulation of Facts, so supplemented, establishes:

(1) The taxpayer was a building contractor and not a dealer or manufacturer; and its taxable income and deductible losses resulted from and were limited to its operations as such contractor.

(2) In making bids and contracts, the emergency material was not considered; and the cost, value, exist-

ence or non-existence thereof had no relation to the contract, the contract price or the taxpayer's profits or losses.

(3) Material was purchased and procured for each specific structure and contract prior to the use of any of the emergency material in such structure; and when emergency material was so "borrowed" and used upon a particular structure it was consistently and promptly replaced with material of like kind and quantity, normally (it may be assumed) utilizing for such replacement purpose the material so theretofore purchased and procured for such specific structure and contract, thus, in truth and substance, as distinguished from mere form, preserving the *status quo ante.*

(4) The agreed purpose or object of the use of such material was (and was so limited) to insure the prompt and orderly execution of contracts in view of delays in shipment and other exigencies affecting the availability for use when needed of the material *theretofore* purchased for the specific structure upon which such emergency material was used.

As a building contractor, the taxpayer's actual income accrued and was solely derived from the performance of its construction contracts, viz., the difference between the cost of such performance upon the one hand, and the money realized for such performanec upon the other. The cost of performing a contract includes and embraces labor, material, insurance, freight and sundry other usual and properly chargeable items of expense. Such cost, when compared with the contract price received, discloses the true income or loss. The aggregate

of its completed contracting operations for the year is determinative of its income, upon which it may be lawfully taxed. *The tax in controversy is in addition thereto.*

The following outline, conforming to the Stipulation of Facts and to the usual course of business, of which the Court will take judicial notice, discloses the methods and scope of the taxpayer's business and the relation of the emergency material thereto.

(a) An owner calls for bids from and submits plans and specifications of a proposed structure to those invited to bid. A typical instance is a bridge constructed for the State of Arizona across the Grand Canyon of the Colorado River or the steel frame of the Federal Reserve Bank Building in Kansas City, Missouri.

(b) Preliminary to submitting a bid, the taxpayer estimates the cost of performing the contract upon the basis of the then cost of all material (including steel), labor, insurance, freight, and all other properly chargeable items of expense, first securing from materialmen firm and binding commitments, based upon the then market price, for all the material to be used in the proposed structure, in absolute disregard of the emergency material and of its cost, value, existence or non-existence. These in the aggregate represent the cost of performing the contract. It then adds its contemplated profit to such aggregate cost; makes its bid accordingly; secures the contract containing penalty provisions for delay in completion beyond an agreed time limit and a bonus for prior completion; converts such prior commitments for all material into final purchases thereof;

and proceeds to the prompt, orderly and expeditious performance of the contract, at the conclusion of which it collects the contract price, plus extras and less deductions, resulting in a *then* profit or loss, as the case may be.

(c) Since the material was previously purchased and procured at the then market price for each specific structure and contract, it was immaterial whether the market price thereof thereafter increased or decreased, for, obviously, such change could not affect the cost of the material so already purchased and procured, or the taxpayer's profit or loss.

(d) It is likewise obvious that the cost, value, existence or non-existence of the emergency material had no relation to the contract or the contract price and was not considered in making the bid. Its agreed relation to and connection with the transaction was limited to the expeditious performance of the contract, or, as stated in the Stipulation of Facts, to "insure the prompt and orderly execution of contracts," in view of delays in shipments, et cetera, "affecting the availability for use, when needed, of the material so purchased and procured." Under these conditions (and not otherwise) it used such portion of the emergency material as the emergency warranted or required, charging the same to the contract at its replacement cost, but upon the condition and under the uniformly consistent plan and practice (constituting but a step in the completed transaction) that the portion of the emergency material so used would be promptly restored or replaced, normally utilizing for that purpose the

material so already purchased and procured for the particular job upon which the emergency material was used. The use of the emergency material was coupled with the concurring obligation to restore it in the manner specified; and no optional alternative existed to do otherwise without departing from the observed practice.

With these ultimate facts in mind, and viewing the transaction as a whole, the relation of the emergency material to the taxpayer's business and income may be tested upon every possible hypothesis with the result that it will be irresistibly demonstrated that such material was in no sense a source of income and contributed nothing to the taxpayer's profit, save only the incidental benefits resulting from the expeditious performance of its contracts, and that every financial aspect of the business was handled without regard to it. Let it be assumed that (1) there had been no such material on hand; (2) or, being on hand, no emergency arose for its use; (3) and that its cost, instead of being $1.70 per hundredweight, was the highest, or the lowest, figure to which the steel market went at any time; wherein would such situations have affected or changed the taxpayer's course of business or the earnings derived therefrom? In other words, if there had been no emergency material on hand at any time, the situation would have been identical, so far as earnings were concerned, and the only difference would have been the want or absence of "the prompt and orderly execution of contracts." Consequently, this material was merely a facility to obviate delays and minimize expense and

possible loss in performance, and had and served no other purpose and produced no other result.

If under any correct legal hypothesis applicable to manufacturers and dealers, an income resulting from a gain in inventory could be discovered as to them under as nearly an analogous state of facts as the nature of their buisness would warrant, the distinction will be apparent by the consideration of the normal relation which an inventory bears to their business, as compared to its non-relation to the taxpayer's business. A taxable gain in inventory, as distinguished from a non-taxable growth or increment in value of property, is naturally and normally limited to a situation where the goods or merchandise constitute the subject matter or stock in trade of the business of the taxpayer, and not, as here, where property is not a necessity but a mere convenient facility for expeditous operation, or where, as here, the business, and the profits thereof, are disconnected with and not dependent upon such property.

The limitation of the statute was recognized by the Board of Tax Appeals in the case of *Atlantic Coast Realty Company* v. *Commissioner of Internal Revenue*, 11 B. T. A. 416, 418, from which, for the general information of the Court, we quote, as follows:

> "The taxpayer with its affiliated corporation, was engaged in buying and selling land for profit. When it filed its consolidated return for 1918 it claimed for the first time that its income should be determined by the use of a so-called inventory of its lands at market value, and upon that basis it reported net income of $14,204.39 and paid a tax of $1,464.53. * * *

We are of opinion that the petitioner has no such right as it claims, that it may not determine its income by revaluing its lands from year to year, and therefore that there is no occasion for findings of fact as to market value of the parcels in question at the close of 1918.

Income is not ordinarily determined by the fluctuations in value of property upward or downward during the continuation of the same ownership. Increment is not added to, nor is a drop in value deducted from, earnings until it has been realized by a sale, loss or other cognizable disposition of the property. Section 203 is a departure from this and it must be limited to its apparent intendment as disclosed in its terms and if necessary in its history. It provides:

> 'That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.'

It was first enacted in the Revenue Act of 1918 and has remained unchanged in each of the later Acts of 1921, 1924 and 1926. In the report on the proposed 1918 Act made by the House Committee on Ways and Means, the Committee said:

> 'In many cases the only way that the net income can be determined is through the proper use of inventories. This is largely true in the case of manufacturing and merchandise concerns. The bill authorizes the Commissioner to require inventories whenever in his opinion the same is necessary in order clearly to reflect the income of the taxpayer.'

> The Senate inserted the words 'conforming as nearly as may be to the best accounting practice in the trade or business,' and thus the section was enacted.
>
> This carefully guarded language may not be construed as creating in all taxpayers the right to determine income by the use of inventory of property on hand. The use of inventories must be reasonably necessary to the determination of income. The basis of their use must be prescribed by the Commissioner, not arbitrarily, but in conformity to the best accounting practice in the trade or business and as most clearly reflecting income. The language indicates no intention to recognize in any trade a new method of determining income or a new limitation upon income, but only a recognition of the use of inventories in such trades or businesses, like 'manufacturing and merchandise concerns,' as had been found to require such accounting practice."

The petitioner makes the point, by way of argument, that since the taxpayer and the Commissioner of Internal Revenue participated in the practice of inventorying the occasional excess material (over and above the 5554 tons of emergency material) the taxpayer thereby conceded the propriety of the application of the inventory regulations to the emergency material. In answer to this point we cite the homely apothegm that, "two wrongs do not make a right." Such excess material should not have been inventoried at all; but, on the contrary, the cost thereof should have been figured into the contracts, thereby contributing to a profit or loss (as the case might be) in the performance of the contracts, determinative at the completion thereof. Such would have been proper accounting and reflective of true income. This was, erroneously, not done and, consequently, the Commissioner of Internal Revenue and the taxpayer substituted the inappropriate practice of inventorying such excess material and a tax was calculated and assessed upon the increase in the value

thereof. Such tax is not in controversy in this case. As pointed out, this method might very well have resulted in an erroneous tax, as the gain in inventory, in a particular year, might have been overcome by the loss resulting from the contracts themselves, completed in a subsequent year when the profits or losses accrued. However, since this excess material was not kept on hand for emergency use and was freed from the practice of borrowing and replacement (distinctions which we urgently emphasize), the application of the inventory regulations thereto may, or may not, have resulted in actual injustice. We submit that, under these circumstances (giving no heed to possible coercion or duress) this feature and aspect of the taxpayer's business has no bearing upon the question involved as to whether or not the inventory regulations should have been applied to the emergency material.

Conclusion.

As we have stated, the decision of the Circuit Court of Appeals is based upon the stipulated facts; and the opinion is such a clear analysis of such facts and so accurately demonstrates, akin to a mathematical certainty, that there was no income forming the subject of the tax, and that the inventory regulations are not applicable to the emergency material, we have taken the liberty of printing the same as an appendix hereto, believing, too, that the convenience of this Court will be thereby enhanced.

We respectfully submit the petitions for the writs should be denied.

Respectfully submitted,

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WILLIAM E. KEMP,
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APPENDIX.

United States Circuit Court of Appeals. Eighth Circuit. May Term, A. D. 1929. *Kansas City Structural Steel Company, Appellant vs. Commissioner of Internal Revenue, Appellee. No.* 8358.

On Petition to Review Decision of the United States Board of Tax Appeals.

Mr. Armwell L. Cooper (Mr. Ellison A. Neel, Mr. Whitson Rogers and Mr. John P. Cooper were with him on the brief), for appellant.

Mr. Randolph C. Shaw, Special Assistant to Attorney General (Mrs. Mabel Walker Willebrandt, Assistant Attorney General, Mr. Sewall Key, Special Assistant to the Attorney General, Mr. C. M. Charest, General Counsel, Bureau of Internal Revenue, and Mr. Clark T. Brown, Special Attorney, Bureau of Internal Revenue, were with him on the brief), for appellee.

Before Lewis, Circuit Judge, and Woodrough and McDermott, District Judges.

McDermott, District Judge, delivered the opinion of the court.

This appeal brings on for review a decision by the Board of Tax Appeals, sustaining a deficiency assessment against the appellant in the sum of $7,656.74. The case was presented to the Board upon a stipulation of facts. The Board made findings of fact, which are substantially as stipulated. There is no record of any evidence being offered in addition to the stipulation, except that the opinion states:

"The evidence establishes clearly that some undeterminable part of the steel on hand in 1916 remained during the taxable years."

Whether there was other evidence of this fact is not material, for it is a natural inference deducible from the facts stipulated and found.

The question presented is whether, in arriving at the taxable income of the appellant, the Commissioner had a right to consider the inventory value of a stock of steel, set apart by the appellant as an "emergency" or "reserve" or "stand-by" stock.

It is stipulated that:

"The Company is engaged in the fabrication and erection of structural steel plates for buildings, bridges, tanks, etc. It fabricates material for specific structures or contracts and carries no finished product in stock. Material is ordered and procured from the mills for each specific structure or contract, except that a supply of material as shown in Exhibit A has been kept on hand for emergency use (from which material is borrowed and replaced) to insure the prompt and orderly execution of contracts in view of delay, etc., incident to shipments from the mills and other exigencies affecting the availability for use when needed of material ordered for a particular job. When such material is used it is charged to the contract at its replacement cost and is promptly replaced with material of a like kind and in a like quantity."

Upon argument, it was stated and not denied, that the business of the taxpayer consisted, in large part at

least, of bidding for the steel work of buildings and bridges and other structures where steel is used; these bids are predicated upon firm offers procured from the mills for the steel involved, plus the cost of fabrication and a profit. If the bid was accepted, the materials were ordered for the job. This seems to be the only inference that can be drawn from the facts stipulated, to-wit, "It fabricates material for specific structures or contracts and carries no finished product in stock," and, "material is ordered and procured from the mills for each specific structure or contract." The taxpayer's business is closely akin to that of a building contractor, which, as far as steel is concerned, it is.

It is further stipulated that this emergency reserve consisted of 5554 tons of structural steel, being the amount on hand on December 31, 1916. Its cost was $1.70 per cwt. F. O. B. Pittsburgh. It is stipulated that this price of $1.70 "represented the highest normal market encountered since 1895." From that date on until December 31, 1921, this steel was treated as above stipulated. All materials of like dimensions were piled piece upon piece in perpendicular piles. This stock varied in size during the year, being both below and above the 5554 tons as material was used therefrom and replaced therein, the extreme limits from 1916 on, for any part of the year, being approximately 4000 and 11,000 tons. Except for the years 1917 and 1921, the reserve exceeded 5554 tons on December 31 of each year. These years are not in controversy and the shortage was inconsiderable. Whenever the reserve exceeded 5554 tons on December 31, the excess was valued at current prices, and a tax paid thereon.

In figuring up its taxable profit for the years 1918 to 1920 inclusive, the appellant treated this emergency steel as a part of its fixed equipment, and carried it at the 1916 cost price of $1.70 per cwt. The stipulation states:

"The Company, at the end of the years 1916, 1917, 1918, 1919 and 1920, valued its said supply of 5554 tons at the cost price prevailing at the close of 1916, or $1.70 per hundred weight F. O. B. Pittsburgh."

Since the reserve did not consist of the identical pieces in the pile on December 31, 1916, and which cost $1.70 per cwt. and since it was impossible to ascertain the cost of the steel actually in the pile, the Commissioner inventoried the entire stock at the market price of the steel most recently purchased, under the rule prescribed by Article 1582, Regulation 45, that the presumption is "the first in, the first out." Whether this presumption is a fair one in the face of the actual probability that workmen would take a girder off the top of a pile instead of the bottom, is challenged by the appellant, but need not be considered.

The result of the two methods of pricing the inventory was that the Government figured the income of the appellant to be $18,230.10 more than the appellant figured it. A deficiency assessment of $7656.74 was made; an appeal to the Board of Tax Appeals was unsuccessful; and the case is here on review.

Since the taxpayer figured this emergency steel as a part of its fixed equipment, no claim was filed for abatement under Sections 214 (a) (12), and 234 (a) (14) of the Revenue Act of 1918, for inventory losses

occurring when prices began to fall. On December 31, 1921, "after prices became normal" and when the price of the steel had dropped below the 1916 level ($1.50) the taxpayer acquiesced in the Government position, and the emergency reserve was priced by the taxpayer at its cost, or market, whichever was lower. It will thus be seen that the taxpayer had 5554 tons of $1.70 steel on hand on December 31, 1916; and 5554 tons of $1.50 steel of a like kind and in a like quantity on hand on December 31, 1921; and that no income had been enjoyed by the taxpayer through its maintenance of this reserve during the five years.

While no claim for abatement was made under the cited sections of the 1918 law, as recited in the stipulation, it does appear that before the Board of Tax Appeals the taxpayer asked credit for a loss in the inventory, due to the falling market in the year 1919. This claim is inconsistent with its present contention, and the record is not clear as to whether the taxpayer asserted this claim as a counter attack, after the Government had asserted the right to tax the paper profits on the same steel during the advancing prices. The Board of Tax Appeals upheld the Government's right to tax the profit on the advancing market, but denied the taxpayer the credit for losses on the falling market because they were not actual losses. The taxpayer has not appealed from that part of the order, but insists that if the Board denies a credit for losses because they are not actual, it ought not to tax income unless it is realized.

The good faith of the taxpayer is not questioned. The stipulation sets out facts indicative of good faith.

The reserve was set apart when prices were at the highest level since 1895; during the succeeding years its market value doubled, and yet the taxpayer did not liquidate it and take its profit; it kept it until prices were below the 1916 level, and it showed a loss; although the amount actually on hand, at the close of the year, was sometimes much more than 5554 tons, it accounted for the excess to the Government. It must be assumed that the reserve was in fact maintained, for the purpose as stipulated, and that it was reasonable in amount.

It will be seen at once that the underlying question is the propriety of including this reserve supply in an inventory taken as an aid to the ascertainment of income. Before dealing with that, it may be as well to consider one or two arguments made by the Government in support of its position. It is urged that in 1921, when prices had gone down, the appellant itself included the entire emergency reserve at 1921 prices, and that the taxpayer applies one rule when prices are high and another when prices are low. The Government makes the very sound argument that one of the prime requisites of any tax system is consistency; that when a taxpayer has adopted one system, it should be adhered to, in fair weather or in foul; and that no taxpayer should be permitted to play fast and loose with his Government. This very fair and sound rule does not apply however where the taxpayer changes his position at the Government's requirement; if the appellant is right in its contention, it cannot be denied relief because it, although still protesting, acquiesced

in the ruling, either because the drop in price had eliminated any substance to the disagreement, or because it became weary of the contest. It is also urged that the appellant, during these very years, included as a part of its income, the increase in value of the excess of the emergency steel over 5554 tons, and thereby attested the correctness of the Government's position. The conclusion does not follow. As to the excess, the appellant doubtless recognized that an emergency supply must bear a fair proportion to the requirements of the business; having determined that 5554 tons was an adequate reserve for a business that fabricated about 30,000 tons a year, it should account for any excess above that amount. Moreover, that the taxpayer may have paid more taxes than it should have, is not adequate reason for a disposition of this case. The Government urges that this is but another claim of the right to set up a "minimum inventory" formerly but unsuccessfully claimed by retailers and dealers. If it is, then the appeal must fail; but that is to assume the correctness of the real controversy, to which we now turn.

Inventories reflect what a man has, and not what he earns; they reflect capital, and not income; many times, in practice, they distort income. Many a merchant has paid an income tax predicated upon the cost or market of goods on his shelves, only to find that by the time the goods were sold, he had sustained a loss instead of a profit. The bankruptcy courts of the deflation period were flooded with claims of unpaid income taxes of the preceding years, a taxation on an in-

come never in fact realized,—a paper profit in an inventory which was turned into a loss in a few short months.

The use of inventories to reflect income is resorted to from necessity. There are a great many business institutions that must either take into account their inventories or not compute their income at all. It is a financial if not a practical impossibility to ascertain the cost and selling price of each spool of thread sold by a retailer, or each sack of flour made by a miller. If it could physically be done, the cost of the bookkeeping would be more than the gross receipts. Hence not only the propriety, but the necessity, of the use of inventories in certain lines of business.

The statute recognizes this, and the statutory power to use inventories is predicated upon necessity. Section 203 of the Revenue Act of 1918 provides:

"That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

The regulation enacted in pursuance thereto provides (Art. 1581, Reg. 45):

"In order to reflect the net income correctly, inventories at the beginning and ending of each year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor."

Foulke on the Federal Income Tax (Sec. 642) says:

"Inventories are necessary in business affairs according to the exigencies of each particular case. The statute provides that inventories shall be used in income tax accounting whenever necessary in the opinion of the Commissioner to clearly determine income. The Commissioner thus has discretion to determine whether or not in fact inventories are necessary and which discretion is no doubt subject to review by the court, although no case appears to have yet arisen. Inventories are necessary in those cases where owing to the quantity of goods or commodities involved in the transaction it is not practicable to keep a separate account of each piece. An inventory is simply a lumping method of determining the gain or loss on the conversion of property in quantities where there is a fluctuation from year to year of the amount on hand, with a practical impossibility of separately itemizing the articles which are added or taken away."

It might correctly be said that the appellant is a fabricator, a constructor, and is not engaged in either the "production, purchase or sale of merchandise," except as incident to its work of construction, just as a builder of houses buys lumber and nails, and gets a lump sum for the finished product. But we prefer that the decision rest on broader grounds.

At the outset, it should be remembered that a wide discretion is vested in the Commissioner, and not in the Courts; and if the business is one where there is any substantial evidence indicating the necessity for the

use of inventories, his decision, backed by majority opinion of the Board of Tax Appeals, should not be disturbed. On the other hand, if, under the agreed facts, a situation is presented where it is clear that the use of an inventory is not only not necessary, but as a matter of fact distorts rather than reflects income, then the appellant has a right to invoke the aid of the courts.

In approaching the problem it should be remembered that all of acts of the Commissioner, all of the Treasury Regulations, all of the taxing statutes, draw their vitality from the Sixteenth Amendment to the Constitution, which gives to Congress the "power to lay and collect taxes on incomes." The Supreme Court said:

"Congress cannot by any definition it may adopt conclude the matter, since it cannot by legislation alter the Constitution, from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised." *Eisner* v. *Macomber*, 252 U. S. 189.

See, to the same effect, *Taft* v. *Bowers*, decided by the Supreme Court of the United States, February 18, 1929, and not yet reported.

The taxing statutes and the regulations prescribe rules and regulations as aids in arriving at true income, and are not designed to create income. In all tax matters, as in most others, the form must give way to the substance. *Eisner* v. *Macomber, supra; Bowers* v. *Kerbaugh*, 271 U. S. 170; *Tucker* v. *Alexander*, 25 F. (2d) 425 (8 C. C. A.). The provisions of

the statute or regulations should not be extended, by implication, beyond the clear import of the language used. "Doubts are resolved against the Government." *Gould* v. *Gould,* 245 U. S. 151; *U. S.* v. *Merriam,* 263 U. S. 179; *Hellmich* v. *Hellman,* 18 F. (2d) 239 (8 C. C. A.). And this Court has said:

"This is, of course, the fundamental purpose of the law that the taxpayer should be taxed upon his actual income and that this should neither be diminished nor increased by any arbitrary or artificial method of computation. As the laws say, 'the true income must be clearly reflected,' and for this purpose the regular and long-standing methods of accounting employed by the taxpayer, established in due course and for no ulterior purpose, are to be indulged.

* * * But, if the books are kept, as the record shows they are, to show the exact state of the income upon completed contracts in each year, it is not perceived how greater difficulty can arise in the case of engineers than in that of building and construction work generally. Furthermore, the Government does not seek to secure a return upon income which is not accurate in fact and which casts an unjust burden upon the taxpayer." *In re Harrington,* 1 F. (2d) 749 (8 C. C. A.).

Income has been authoritatively defined as "the gain derived from capital, from labor, or from both combined," and in referring to that definition the Supreme Court has said:

"Brief as it is, it indicates the characteristic and distinguishing attribute of income, essential for a

correct solution of the present controversy. The Government, although basing its argument upon the definition as quoted, placed chief emphasis upon the word 'gain,' which was extended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived—*'derived—from—capital'—'the gain—derived—from—capital,'* etc. Here we have the essential matters; *not* a gain *accruing* to capital, not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital, however invested or employed, and *coming in*, being *'derived,'* that is, *received or drawn by* the recipient (the taxpayer) for his separate use, benefit, and disposal; *that* is income derived from property. Nothing else answers the description." (Italics by the court.) *Eisner* v. *Macomber*, 252 U. S. 189.

The regulations cannot be broader than the statute. The statute authorizes the use of inventories, when, "in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer * * *." While no case has apparently decided the question, it is undoubtedly true that the opinion of the Commissioner must be predicated upon facts reasonably justifying it; it may not be arbitrary. Foulke on The Federal Income Tax, Sec. 642.

Is there any basis for determining that an inventory of this emergency steel is necessary in arriving at appellant's income, prior to the time when it is liquidated? It is stipulated that the appellant "carries no

finished product in stock''; that is, unlike a retailer or wholesaler, or a miller, it is not a dealer. ''It fabricates material for specific structures or contracts''; that is, it gets a contract first, and then does the work. Except for the supply in question, and the excess inventory on which taxes are paid, ''material is ordered and procured from the mills for each specific structure or contract''; that is, it buys on the market and at the market for each job. Sometimes, when work is progressing, the material ordered is delayed in shipment or transit; rather than delay the job, then and then only—''for emergency use (from which material is borrowed and replaced)'' —the reserve steel in question is resorted to. When it is so used, ''it is charged to the contract at its replacement cost and is promptly replaced with material of a like kind and in a like ~~quality~~ quantity;''—presumably, as stated in argument, from the delayed car.

We have then this situation: the appellant is fabricating steel at Kansas City, some distance from steel mills; realizing the chance of delayed shipments, and in order to be able to compete in prompt execution of its contracts with other plants located near the mills, it carries a ''stand-by'' stock, replacing each girder used therefrom by the one ordered. There is in fact no profit at all realized from this emergency supply, other than the reputation of promptly doing the work. The profit of each job is exactly the same as if it had no such reserve. The profit is the same as if it borrowed the steel from a neighbor instead of from this pile. In fact, it might very well be that half this reserve steel would go into a bridge that showed a

loss on the entire contract. The pile is the same on December 31, 1916, as it is on similar days in each succeeding year, except for the two years noted and not here involved. As long as it remains intact, there is no income from it, no matter what the market fluctuations are. When, if ever, it is liquidated, there will then be a profit or loss, but until then it is like its derricks and its cranes and its buildings; it is useful in the business, but until liquidated, can show only paper profits which are neither realized nor taxable.

Upon argument it was urged that when the taxpayer took $1.70 steel out of the pile and put it in a $4.00 contract, he made a profit; and whether he reinvested that profit in other steel that went into the pile, is immaterial. This overlooks the stipulated facts. The taxpayer's contract was figured on $4.00 steel which he ordered from the factory; if a $1.70 girder was "borrowed" from the pile today, put into a bridge, and "replaced" tomorrow in "kind" with a $4.00 girder, there is no profit as long as he keeps the $4.00 girder for emergency use. In the briefs, it is argued that the appellant is like a merchant, who constantly replenishes his stock, always striving to keep a stock on hand to meet the demands of his trade. That but begs the question. In the first place, inventories are "necessary" for the multitudinous transactions of merchants, who buy first and sell afterward; they are not necessary for those who keep no finished stock, who sell no goods, and who always contract first and buy afterward. Moreover, merchants keep no stand-by stock for years, promptly replacing in kind each item borrowed therefrom.

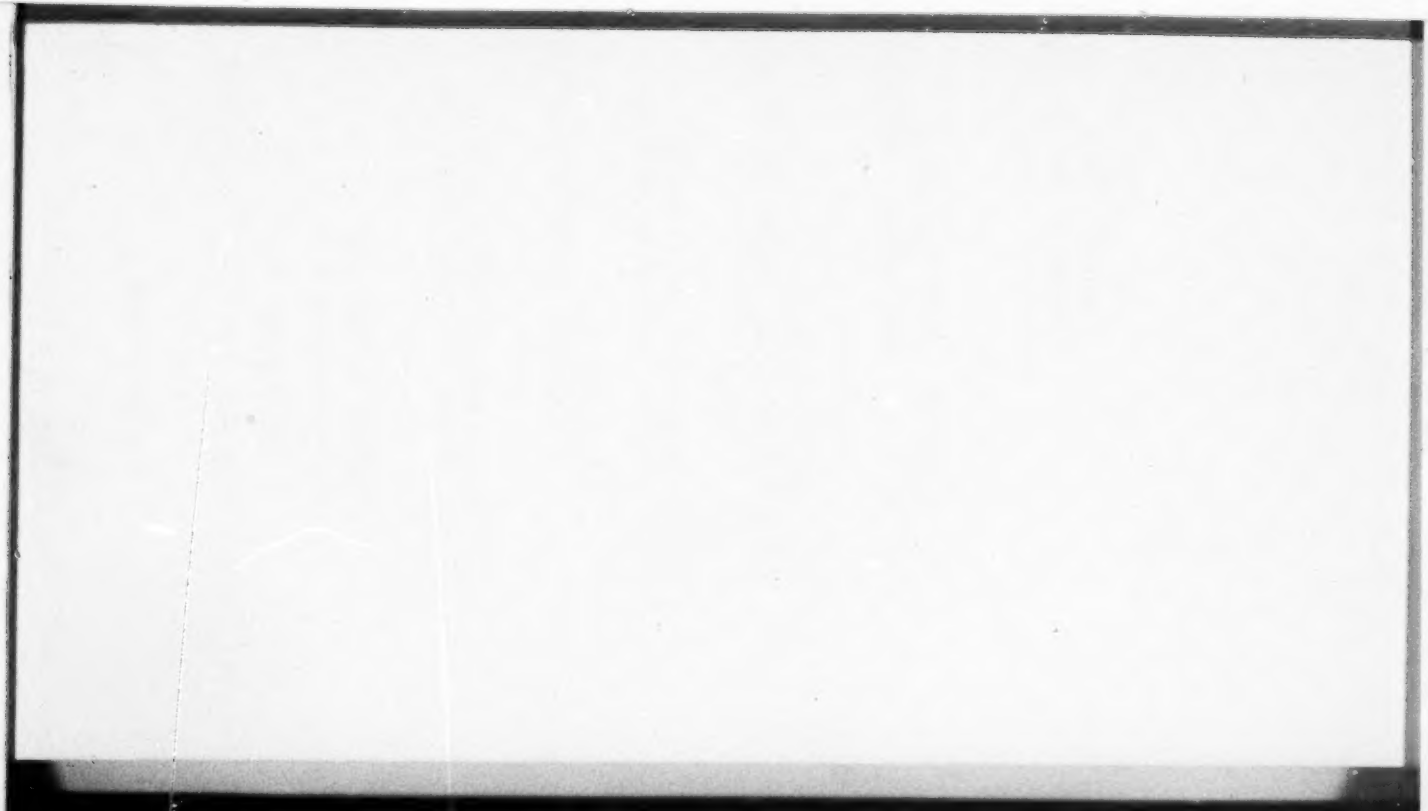
Taking the whole business of the taxpayer, as stipulated, and bearing in mind the admonition that the substance and not the form controls, we cannot escape the conclusion that, as a matter of fact, the existence or absence of this emergency supply doesn't add a dollar to the profit the taxpayer made on any contract he has ever executed; under the facts, it cannot affect his income, except as a good reputation helps him to other contracts, upon which he will pay a tax. When he abandons or cuts down the emergency pile, then he must account for his profit over the 1916 price of $1.70; but, like his cranes and derricks, until he does dispose of them, no taxable income accrues from the mere ownership. The facts in this case show that on December 31, 1916, this steel cost the taxpayer $1.70 per cwt. All during the years he kept it up and used it as an emergency reserve; in December 1921, it took it into account for tax purposes,—a theoretical liquidation. On that date, it was worth $1.50 per cwt., twenty cents less than it paid for it in 1916. Yet, by virtue of its ownership, the Government has assessed a tax predicated on a profit of $18,000.00. True, income must be on an annual basis, and losses of this year may not offset profits of last. But here there was no actual profit in any year, and no actual profit when liquidated. An Iowa farmer who owned $150.00 an acre land in 1916, and who sold it in 1924 for $150.00 an acre, cannot be taxed because in 1918 or 1919 it had a market value of $300.00 an acre. This analogy, it is true, overlooks the specific individuality of two identical girders which may be interchanged one day

with the next—"borrowed" and "replaced." But that is of the form rather than of the substance. The appellant derived no income during the years from the ownership of this emergency supply; it was a part of its equipment for doing business; its business was such that it was not necessary to include it in the inventory to arrive at actual income; to so consider it, distorts rather than reflects, the true income of the taxpayer.

This decision is necessarily confined to the facts of this particular business. If the appellant were a merchant or a manufacturer, where inventories were necessary to arrive at income, it must take into account all of its stock, and cannot set apart a "minimum" inventory. If the appellant, a builder, used this emergency supply for tucking away profits actually made, it could not escape. If there was bad faith, or an excessive reserve, it would be otherwise. If it liquidated the pile and took its profit, it must pay. But these are not the stipulated facts. The stipulated facts show a builder, who keeps a supply of building materials against an emergency; it is reasonable in amount; it does not liquidate it on a high market and take its profit; it held it for years as a part of its fixed equipment; it never made a dollar out of it except as it enabled it to secure other contracts on the profits of which it paid a tax; its existence produced no income and there should be no tax.

The order appealed from in this case, and in No. 8359, stipulated to abide this case, are reversed.

Filed May 14, 1929.



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Nos. 323 and 324.

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1929.

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

VS.

KANSAS CITY STRUCTURAL STEEL COMPANY, RESPONDENT.

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

VS.

KANSAS CITY STRUCTURAL STEEL COMPANY, RESPONDENT.

BRIEF ON BEHALF OF RESPONDENT, KANSAS CITY STRUCTURAL STEEL COMPANY.

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BRIEF ON BEHALF OF RESPONDENT, KANSAS CITY STRUCTURAL STEEL COMPANY.

(1) There was no income upon which to assess the tax.

(2) The Inventory Statute and the Departmental Regulations made in pursuance thereof are not applicable to respondent's business nor to the emergency material in question.

Respondent asserts and petitioner denies the correctness of the above propositions, the second being but a corollary of the first, for, as of course, there

can be no tax without income. The court below upheld respondent's contentions and reversed the judgment of the United States Board of Tax Appeals which held to the contrary. Consequently, we conceive it to be our proper duty (fully and accurately, but as briefly and succinctly as we can), to present and apply the agreed facts that it may be determined therefrom whether there was any income constituting the subject of the tax and also whether the Inventory Statute and the regulations thereunder are applicable and serve to aid in determining the primary question, viz.: Was there any income upon which to assess the tax?

The judgment of the United States Board of Tax Appeals was promulgated April 30, 1928, affirming, by a divided vote, the action or judgment of the Commissioner of Internal Revenue in assessing an additional or deficiency income tax against the respondent for the years 1918 and 1920. Upon appeal of the taxpayer, this judgment was reversed by the United States Circuit Court of Appeals for the Eighth Circuit. The cases are here, by certiorari, upon petitions of the Commissioner of Internal Revenue. The tax was made up of several items, but this case involves only the portion based upon an alleged gain in inventory of 5554 tons of unfabricated structural steel and steel plates set aside and kept on hand for emergency use. The other items, not here involved, have since been paid.

The cases, as to both years, were tried and submitted upon one agreed statement of all the facts, which will be found at page 16 of the printed record. The disputed tax for the year 1918, amounts to $7,656.74

(Case No. 323) and for the year 1920, to $15,953.36 (Case No. 324). The latter case was submitted below upon the record in the former, pursuant to the stipulation set forth on page 44 of the record in this court. The same situation exists here, for, as said in the stipulation referred to, "the questions of law involved * * * are identical * * * and * * * the facts are similar with the exception of certain amounts and the years involved."

The Facts.

The respondent was engaged in the business of fabricating and erecting, by contract, structural steel and steel plates for buildings, bridges, tanks and other structures. It fabricated and erected such material for each specific structure and contract. Material was ordered and procured, at the then market price, from the rolling mills for each specific structure and contract. However, a supply of material was kept on hand for emergency use only (under the practice herein set out) to insure the prompt and orderly execution of contracts, in view of delays incident to shipments from the mills and other exigencies affecting the availibility for use, when needed, of the material theretofore ordered and procured for the particular and specific jobs. The uniform and consistently observed plan and practice was that when, in such emergencies, material was so used from such supply, it was charged to the contract at its replacement cost, viz., the cost of the material already purchased, and upon receipt of the like material previously purchased for the particular job

upon which such emergency material was used, was promptly replaced with material of a like kind and in a like quantity. The respondent was not a merchant, dealer or manufacturer and such material was not for sale and did not constitute a merchandising stock. On the contrary, it was a construction or building contractor for the delivery of the completed structure in place, involving and embracing all labor and material. The emergency material was very heavy and was kept in convenient piles of like kind. When such material was so used it was taken from the top of the pile (the Commissioner of Internal Revenue assumed it was taken from the bottom) and the replacement material was put on top of the pile from which the used material was taken or borrowed. The amount of such material on hand on December 31, 1916, was 5554 tons, which the respondent set aside and substantially maintained for such emergency use (and not otherwise) under the practice aforesaid, and carried it at its cost of $1.70 per hundred weight f. o. b. Pittsburgh, Pa. An alleged gain in inventory of this material forms the basis of the tax in controversy, which is in addition to the tax upon the respondent's income derived from the normal conduct of its contracting business determinative as of the year of the completion of the contracts.

The respondent contends that no income did (nor could prior to final liquidation) accrue from such emergency material as a basis for the imposition of the tax complained of, whereas the Commissioner of Internal Revenue priced the same at the end of the year

at the cost of a corresponding quantity of the most recent purchase of similar material and assessed a tax upon an assumed income based upon the difference between the value thereof, as of December 31, 1917, and December 31, 1919, respectively, and the higher value thereof, as of December 31, 1918, and December 31, 1920, respectively. This resulted in a fictitious increase of the respondent's taxable income, and the additional or deficiency tax which is in controversy.

The stipulation of facts upon which the case was tried provides (R. 16):

> "The company is engaged in the fabrication and erection of structural steel plates for buildings, bridges, tanks, etc. It fabricates material for specific structures or contracts and carries no finished product in stock. Material is ordered and procured from the mills for each specific structure or contract, except that a supply of material, as shown in Exhibit A, has been kept on hand for emergency use (from which material is borrowed and replaced) to insure the prompt and orderly execution of contracts in view of delay, etc., incident to shipments from the mills and other exigencies affecting the availability for use when needed of material ordered for a particular job. When such material is used it is charged to the contract at its replacement cost and is promptly replaced with material of a like kind and in a like quantity" (R. 16).

> "The company, at the end of the years 1916, 1917, 1918, 1919 and 1920, valued its said supply of 5554 tons at the cost price prevailing at the close of 1916, or $1.70 per hundredweight f. o. b. Pittsburgh" (R. 17).

"The Commissioner of Internal Revenue in pricing the inventory of the company has disregarded the said fixed quantity of 5554 tons assuming that the last purchases represented the entire inventory and using said last purchases as a basis for valuation" (R. 17).

The Board of Tax Appeals, in its opinion, said (R. 20):

"The petitioner is a corporation organized and existing under the laws of the State of Missouri, with its offices at Kansas City, Missouri.

During the taxable year it was engaged in the fabrication and erection of structural steel plates for buildings, bridges, tanks, etc., and fabricated material for specific structures or contracts. It carried no finished product in stock. Material was ordered and procured from the mills for each specific structure or contract, except that a supply of material was kept on hand for emergency use to insure the prompt and orderly execution of contracts. When such material was used, it was charged to the contract at its replacement cost and promptly replaced with material of a like kind in a like quantity."

The theory on which the Board decided the case is disclosed by the following language used by it (R. 24):

"In fact, however, each sale or exchange of the individual items of the inventory is a realization of taxable profit or deductible loss in the year in which it occurs, and a method of accounting which disregards such realization does not truly reflect income. After the profit is realized it is immaterial whether it is immediately reinvested in inventory or is invested in some other manner. It is taxable when realized."

I.

The respondent contends that this 5554 tons of material contributed nothing to its income and had no relation thereto; and that therefore there was no income upon which to assess the tax.

As stated, the case was tried upon a stipulation of the ultimate facts, amounting to a special verdict with which the judgment must be in harmony (*Wastun* v. *Lincoln Nat. Life Ins. Co.*, 12 F. (2d) 422). Moreover, it was the duty of the Board of Tax Appeals to supplement (as this court will do) the agreed facts with its judicial knowledge "of the general course of business and the usual methods of transacting it" (23 C. J. 62) and in connection therewith, to not "close our (its) eyes to the well known course of business in the country" (*Bank of Kentucky* v. *Adams Express Co.*, 93 U. S. 174, 185).

The Stipulation of Facts, so supplemented, establishes:

(a) The respondent was a building contractor and not a dealer, producer or manufacturer; and its taxable income and deductible losses resulted from and were limited to its profits or losses accruing from the performance of its construction contracts, determinative as of the date of the completion thereof.

(b) In making bids and contracts, the emergency material was not considered; and the cost, value, existence or non-existence thereof had no relation to the contract, the contract price or the respondent's profits or losses.

(c) Material was purchased and procured for each specific structure and contract prior to the use of any of the emergency material in such structure; and when emergency material was so "borrowed" and used upon a particular structure it was consistently and promptly "replaced" with material of like kind and quantity, normally and naturally utilizing for such replacement purpose the material so theretofore purchased and procured for such specific structure and contract, thus, in truth and substance as distinguished from mere form, preserving the *status quo ante.*

(d) The agreed purpose or object of the use of such material was (and was, concededly, so limited) to insure the prompt and orderly execution of contracts in view of delays in shipment and other exigencies affecting the availability for use when needed of the material theretofore purchased for the specific structure upon which such emergency material was used.

As a construction contractor, the respondent's actual income accrued and was solely derived from the performance of its construction contracts, viz., the difference between the cost of such performance upon the one hand, and the money realized for such performance upon the other. The cost of performing a contract includes and embraces labor, material, insurance, freight and sundry other usual and properly chargeable items of expense. Such cost, when compared with the contract price received, discloses the true income or loss. The aggregate of its completed contracting operations for the year is determinative of its income, upon which

it may be lawfully taxed. The tax in controversy is in addition thereto.

The dissenting opinion of His Honor, Judge Woodrough (R. 40), in this regard, well says:

> "The tax-payer being a contractor, of course its true income for any year was the difference between the receipts from its contracts and the cost to it of fulfillment, due allowances being made."

The following outline, conforming to the stipulation of facts and to the usual course of business, of which the court will take judicial notice, discloses the methods and scope of the respondent's business, its sole source of profits and the relation of the emergency material thereto.

(a) An owner calls for bids from and submits plans and specifications of a proposed structure to those invited to bid. Typical instances are a bridge constructed for the State of Arizona across the Grand Canyon of the Colorado River, the steel frame of the Federal Reserve Bank Building in Kansas City, or a colony of 55,000 barrel oil tanks, in place, for a producing oil company in the Mid-Continent field.

(b) Preliminary to submitting a competitive bid, the contractor estimates the cost of performing the contract upon the basis of the then cost of all material (including steel), labor, insurance, freight, and all other properly chargeable items of expense, first securing from materialmen firm commitments, based upon the then market price, for all the material to be used in the proposed structure, in absolute disregard of the emer-

gency material and of its cost, value, existence or non-existence. These in the aggregate represent the cost of performing the contract. It then adds its contemplated profit to such aggregate cost; makes its bid accordingly; secures the contract containing penalty provisions for delay in completion beyond an agreed time limit and a bonus for prior completion; converts such prior commitments for material into final purchases thereof; and proceeds to the prompt, orderly and expeditious performance of the contract, at the conclusion of which it collects the contract price, plus extras and less deductions, resulting in a then profit or loss, as the case may be.

(c) Since the material was previously purchased, at the then market price, for each specific structure and contract, it is immaterial whether the market price thereof thereafter increased or decreased, for, obviously, such change could not affect the cost of the material so already purchased, or the contractor's profit or loss.

(d) It is likewise obvious that the cost, value, existence or non-existence of the emergency material had no relation to the contract or the contract price and was not considered in making the bid. Its *agreed* relation to and connection with the transaction was limited to the expeditious performance of the contract, or, as stated in the stipulation of facts, to "insure the prompt and orderly execution of contracts," in view of delays in shipments, *et cetera,* affecting the availability for use, when needed, of the material "so purchased and procured." Under these conditions (and not otherwise) it used such portion of the emergency ma-

terial as the emergency warranted or required, charging the same to the contract at its replacement cost, but upon the condition and under the uniformly consistent plan and practice (constituting but a step in the completed transaction) that the portion of the emergency material so "borrowed" and used would be promptly "replaced," normally and naturally utilizing for that purpose the material so already purchased for the particular job upon which the emergency material was used. The use of the emergency material was coupled with the concurring obligation to restore it in the manner specified; and no optional alternative existed to do otherwise without departing from the agreed (and observed) practice.

With these ultimate facts in mind, and viewing the transaction as a whole, the relation of the emergency material to the respondent's business and income may be tested upon every possible hypothesis with the result that it will be irresistibly demonstrated that such material was in no sense a source of income and contributed nothing to the taxpayer's profit (save only the incidental benefits resulting from the expeditious performance of its contracts), and that every financial aspect of the business was handled without regard to it. Let it be assumed that (1) there had been no such material on hand; (2) or, being on hand, no emergency arose for its use; (3) and that its cost, instead of being $1.70 per hundred weight, was nothing, or the highest, or the lowest, figure to which the steel market went at any time; wherein would such situations have affected or changed the respondent's course of business or the

earnings derived therefrom? In other words, if there had been no emergency material on hand at any time, the situation would have been identical, so far as earnings were concerned, and the only difference would have been the want or absence of the prompt and orderly execution of contracts resulting from the delay incident to shipments from the mills and other exigencies affecting the availability for use when needed of material ordered for a particular job. Such are the stipulated facts. Consequently, this material was merely a facility to obviate delays and minimize expense and possible loss *in performance* of contracts, and had and served no other purpose and produced no other result. It was a convenient facility and not a necessity, which is not the case with a producer, manufacturer or dealer to which the inventory regulations apply as will be hereafter pointed out.

We submit the demonstrative illustration that if the taxpayer's operations as a construction contractor had produced neither profit nor loss, leaving only the fictitious income complained of, it would have been without earned funds with which to pay the tax thereon and could look only to its capital and surplus therefor. In such a case, by no system of economics or accounting could there be found a farthing with which to pay the tax, save only, as stated, from capital and surplus. There can be no such destructive conflict between good law and good business, for income is the *sine qua non* of the tax. Substance, not form, controls, and "the letter killeth, but the spirit giveth life" (I Cor. 3:6), an exhilarating doctrine in lively contrast

with the depressing heresies announced by the Commissioner of Internal Revenue and Board of Tax Appeals in this case.

The principles announced in the following decisions of this Court and of various of the Courts of Appeals apply to the situation above disclosed.

In *Eisner* v. *Macomber*, 252 U. S. 189, l. c. 206 (64 L. Ed. 521, l. c. 528), the court said:

> "In order, therefore, that the clauses cited from Article I of the Constitution may have proper force and effect, save only as modified by the amendment, and that the latter also may have proper effect, it becomes essential to distinguish between what is and what is not 'income,' as the term is there used; and to apply the distinction, as cases arise, according to truth and substance, without regard to form. Congress cannot by any definition it may adopt conclude the matter, since it cannot by legislation alter the constitution, from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised."

In *Bowers* v. *Kerbaugh*, 271 U. S. 170, l. c. 174 (70 L. Ed. l. c. 888), the Supreme Court again said:

> "In determining what constitutes income, substance rather than form is to be given controlling weight."

The court in *Tucker* v. *Alexander*, 25 F. (2d) 425, l. c. 428, said:

> "Substance and not form must govern in construing and applying income tax laws. *United States* v. *Phellis*, 257 U. S. 156, 168, 42 S. Ct. 63, 66 L. Ed. 180. The transaction must be viewed as a whole because it was a unit. Each step therein was necessary to its completion."

In *In re Harrington,* 1 F. (2d) 749, l. c. 750, it is said:

> "This is, of course, the fundamental purpose of the law that the taxpayer should be taxed upon his actual income and that this should neither be diminished nor increased by any arbitrary or artificial method of computation. As the law says, 'the true income must be clearly reflected,' and for this purpose the regular and long-standing methods of accounting employed by the taxpayer, established in due course and for no ulterior purpose, are to be indulged. * * * But, if the books are kept, as the record shows they are, to show the exact state of the income upon completed contracts in each year, it is not perceived how greater difficulty can arise in the case of engineers than in that of building and construction work generally. Furthermore, the government does not seek to secure a return upon income which is not accurate in fact and which casts an unjust burden upon the taxpayer."

In *In re Sheinman,* 14 F. (2d) 322, l. c. 325, the court said:

> "The ascertainment of the amount of the net taxable income of the taxpayer is the ascertainment of a fact. Real facts, and not bookkeeping entries, give rise to income. Books of account are no more than evidential. They are neither indispensible nor conclusive. *Doyle* v. *Mitchell,* 247 U. S. 179, 38 S. Ct. 467, 62 L. Ed. 1054; *Southern Pacific Railroad* v. *Muenter,* 260 F. 837, 171 C. C. A. 563; *Douglas* v. *Edwards,* (C. C. A.) 298 F. 229. *Baldwin Locomotive Works* v. *McCoach,* 221 F. 59, 136 C. C. A. 660."

Haugh & Keenan Storage & Transfer Co. v. *Heiner,* 20 F. (2d) 921, l. c. 922, states the following rule:

> "The government proceeded on the theory that because the books and records of the plaintiff did

not disclose depreciation provided for in a certain way, or according to a certain rule, therefore it must be presumed that depreciation was not provided for at all. Taxes are not laid and collected on theory, but on a situation actually existing, as the facts may show that situation to be. Theory is applied in the absence of such facts. The question of taxation is one of fact, and cannot turn on theories or fiction. *In re Curtis,* 142 N. Y. 219, 36 N. E. 887; *Swift's Estate,* 137 N. Y. 77, 32 N. E. 1096, 18 L. R. A. 709."

II.

As to the second proposition, the Circuit Court of Appeals held that the Inventory Statute and the Inventory Regulations are not applicable to the emergency material at all for the reason, among others, that, under the agreed facts, it clearly appears there was no income derived therefrom and consequently there can be no tax. We are not contending for the so-called "base," "constant" or "minimum" inventory theory, nor did the court below recognize or apply the same.

In the majority opinion, it is said (R. 34):

"The government urges that this is but another claim of the right to set up a 'minimum inventory' formerly but unsuccessfully claimed by retailers and dealers. If it is, then the appeal must fail. * * *"

In the minority opinion, it is said (R. 42):

"I understand it is not intended to strike down the acts and regulations concerning resort to inventory for income tax assessments, but the court discerns in the case of this taxpayer a peculiar situation amounting to an exception."

Inventories are not designed or resorted to to create income but to ascertain or determine income, and "• • • are necessary in business affairs according to the exigencies of each particular case" (Foulke, Federal Income Tax, Sec. 642).

If under any correct legal hypothesis relating to the business of manufacturers and dealers, an income resulting from a gain in inventory could be discovered as to them under as nearly an analogous state of facts as the nature of their business would warrant, the distinction will be apparent by the consideration of the normal relation which an inventory bears to their business, as compared to its non-relation to respondent's business. A taxable gain in inventory, as distinguished from a non-taxable growth or increment in value of property, is naturally and normally limited to a situation where the goods or merchandise constitute the subject matter or stock in trade of the business of the taxpayer, and not, as here, where property is not a necessity but a mere convenient facility for expeditious performance of contracts, or where, as here, the business, and the profits thereof, are disconnected with and not dependent upon such property.

The Departmental Regulation promulgated in pursuance of the Inventory Statute, shows its restricted application to cases in which the "production, purchase or sale of merchandise is an income producing factor," and thereby excludes from the effect thereof the contracting business of the respondent. It can not correctly be said that a building contractor is engaged in the business of "producing" or "manufacturing" a

building or structure, nor does he "sell" the same. The business of a building contractor is recognized, in the business world, as being entirely different and distinct from that of a manufacturer or producer of merchandise or commodities and also from that of a merchant or a dealer in merchandise or commodities. The fabrication of a steel beam or plate is no different from what a carpenter does with wood in fashioning it to fit in its allotted place in a building or structure. Steel, brick, concrete, stone and wood merely require different tools and equipment to "fabricate" and to handle them in connection with a building, bridge, or other structure.

The Regulation referred to (formerly Art. 1581, Reg. 45, now Art. 101, Reg. 74) reads as follows:

> "In order to reflect the net income correctly, inventories at the beginning and end of each year are necessary in every case in which the production, purchase or sale of merchandise is an income-producing factor. The inventory should include raw materials and supplies on hand that have been acquired for sale, consumption, or use in productive processes, together with all finished or partly finished goods. * * *"

The limitation of the statute was recognized by the Board of Tax Appeals in the case of *Atlantic Coast Realty Company* v. *Commissioner of Internal Revenue*, 11 B. T. A. 416, 419. This decision (a rather extensive extract from which is printed as an appendix to this brief) discusses the history of the Inventory Statute in connection with congressional action thereon, and concludes:

> "This carefully guarded language may not be construed as creating in all taxpayers the right

to determine income by the use of an inventory of property on hand. The use of inventories must be reasonably necessary to the determination of income. The basis of their use must be prescribed by the Commissioner, not arbitrarily, but in conformity to the best accounting practice in the trade or business and as most clearly reflecting income. The language indicates no intention to recognize in any trade a new method of determining income or a new limitation upon income, but only a recognition of the use of inventories in such trades or businesses like 'manufacturing and merchandise concerns,' as had been found to require such accounting practice."

The petitioner at page 11 of his brief in support of his petition for the writs of certiorari, says:

"This taxpayer is not a mere contractor, but a manufacturer who buys raw material in the form of plates and bars and fabricates it into the frame work of bridges and buildings. The steel it used did not all come direct from the mills, but a large part of it came from its own reserve supply. • • • The orders placed at the mills were not merely to take care of the particular job at hand, but also to replenish the reserve supply in preparation for anticipated future contracts.

The facts in this case, we submit, are therefore not unique; they are more or less typical of large numbers of other cases in which manufacturers maintain stocks of raw material for use in their productive processes. The stock here, like most other stocks, was kept in good faith; it was reasonable in amount; and it was necessitated by the remoteness of the more general supply."

In his final brief here, petitioner, in effect, makes the same contentions, contrary to the agreed facts. Respondent is not a manufacturer; material *is* ordered for each

job; and respondent buys no "raw material." What we have heretofore said sufficiently shows the nature and character of respondent's business and the stipulation of facts permits of no other conclusion than that reached by the court below that respondent is a building contractor and nothing else. The statement that respondent buys "raw material" from the rolling mills in the form of structural steel, bars and plates, discloses an entire misconception of what is and what is not raw material. As well say that a board or wooden beam, to which the saw and auger of the mechanic are applied, is raw material as to say that a steel beam or plate, to which a dissimilar saw and auger are applied is raw material. The operator of a sawmill manufactures lumber, but the building contractor who fits, fashions and places it in a building is not a manufacturer. Similarly, the processes by which iron ore and other ingredients are converted into steel and rolled into bars, beams and plates properly comes under the designation of manufacturing. But the building contractor who fits, fashions and places them in their allotted place in a building, bridge or other structure is not a manufacturer. And by the same token, the lumber and steel, as they reach the contractor, are not raw material.

The petitioner makes the point, by way of argument, that since the taxpayer and the Commissioner of Internal Revenue participated in the practice of inventorying the sometimes excess material (over and above the 5554 tons) the taxpayer thereby conceded the propriety of the application of the inventory regula-

tions to the emergency material in question. In answer to this point we cite the homely apothegm that, "two wrongs do not make a right." Such excess material should not have been inventoried at all; but, on the contrary, the cost thereof should have been figured into the contracts, thereby contributing to a profit or loss (as the case might be) in the performance of the contracts, determinative at the completion thereof. Such course would have been reflective of true income. This was, erroneously, not done, and, consequently the Commissioner of Internal Revenue and the taxpayer substituted the inappropriate practice of inventorying such excess material and a tax was calculated and assessed upon the increase in the value thereof. Such tax is not in controversy in this case. As pointed out, this method may very well have resulted in an erroneous tax (and necessarily did so result if the agreed method was likewise observed as to it) as the gain in inventory, in a given year, may have overcome and exceeded the losses resulting from the completed contracts themselves, thereby producing a tax without income; or, conversely, augmented its true income derived from its contracting operations, correspondingly (and improperly) increasing its tax. On this point the court below said (R. 34):

> "It is also urged that the appellant, during these very years, included as a part of its income, the increase in value of the excess of the emergency steel over 5554 tons, and thereby attested the correctness of the government's position. The conclusion does not follow. As to the excess, the appellant doubtless recognized that an emergency supply must bear a fair proportion to the re-

quirements of the business; having determined that 5554 tons was an adequate reserve for a business that fabricated about 30,000 tons a year, it should account for any excess above that amount. *Moreover, that the taxpayer may have paid more taxes than it should have, is not adequate reason for a disposition of this case*" (italics ours).

The case was decided by the Board of Tax Appeals upon the unwarranted assumption that respondent *sold* the emergency material, *collected* the proceeds thereof and *reinvested* it in other steel, patently disregarding the nature and character of respondent's business as a construction or building contractor. It said (R. 24):

> "In fact, however, each sale or exchange of the individual items of the inventory is a realization of taxable profit or deductible loss in the year in which it occurs, and a method of accounting which disregards such realization does not truly reflect income. After the profit is realized it is immaterial whether it is immediately reinvested in inventory or is invested in some other manner. It is taxable when realized."

There is no language in the stipulation of facts warranting such a construction or justifying such a conclusion. On the contrary, it is clearly stated that it "fabricates material for specific structures or contracts," that material "is ordered and procured from the mills for each specific structure or contract" and that the emergency material "has been kept on hand for emergency use (from which material is borrowed and replaced) to insure the prompt and orderly execution of contracts. * * *" May we ask how these sales were effected or the proceeds thereof collected and by

what manner or means the same could have been "invested in some other manner" or in material *already* "purchased and procured." There was no "sale," the relation of vendor and vendee at no time existing in any feature or aspect of respondent's contracting business. The board also overlooked or disregarded the fact that respondent's profits or losses accrue and are determinative as of the date of the completion of its construction contracts irrespective of when the contracts are made or the material is used or the work is done. A contract made August first and completed January tenth would, for tax purposes, belong to the latter year although ninety per cent of the work was done and ninety-five per cent of the material was used during the former year. The Board of Tax Appeals gave no heed or consideration to these true facts and conditions and consequently failed to see that this material and the use thereof contributed nothing to respondent's income, save only the indirect and incidental benefits resulting from the agreed purpose of the use thereof.

III.

Upon both issues, heretofore considered, that (a) there was no income upon which to assess the tax, and (b) the Inventory Statute and Regulations do not apply, we cite and adopt as a part of our brief and argument the following clear, analytical and accurate discussion found in the majority opinion of the court below (R. 37):

> "Is there any basis for determining that an inventory of this emergency steel is necessary in arriving at appellant's income, prior to the time

when it is liquidated? It is stipulated that the appellant 'carries no finished product in stock'; that is, unlike a retailer or wholesaler, or a miller, it is not a dealer. 'It fabricates material for specific structures or contracts'; that is, it gets a contract first, and then does the work. Except for the supply in question, and the excess inventory on which taxes are paid, 'material is ordered and procured from the mills for each specific structure or contract'; that is, it buys on the market and at the market for each job. Sometimes, when work is progressing, the material ordered is delayed in shipment or transit; rather than delay the job, then and then only—'for emergency use (from which material is borrowed and replaced)' —the reserve steel in question is resorted to. When it is so used, 'it is charged to the contract at its replacement cost and is promptly replaced with material of a like kind and in a like quantity';— presumably, as stated in argument, from the delayed car.

We have then this situation; the appellant is fabricating steel at Kansas City, some distance from steel mills; realizing the chance of delayed shipments, and in order to be able to compete in prompt execution of its contracts with other plants located near the mills, it carries a "stand-by" stock, replacing each girder used therefrom by the one ordered. There is in fact no profit at all realized from this emergency supply, other than the reputation of promptly doing the work. The profit of each job is exactly the same as if it had no such reserve. The profit is the same as if it borrowed the steel from a neighbor instead of from this pile. In fact, it might very well be that half this reserve steel would go into a bridge that showed a loss on the entire contract. The pile is the same on December 31, 1916, as it is on similar days in each succeeding year, except for the two years noted and not here involved. As long as it remains intact, there is no income from it, no

matter what the market fluctuations are. When, if ever, it is liquidated, there will then be a profit or loss, but until then it is like its derricks and its cranes and its buildings; it is useful in the business, but until liquidated, can show only paper profits which are neither realized nor taxable.

Upon argument it was urged that when the taxpayer took $1.70 steel out of the pile and put it in a $4.00 contract, he made a profit; and whether he reinvested that profit in other steel that went into the pile, is immaterial. This overlooks the stipulated facts. The taxpayer's contract was figured on $4.00 steel which he ordered from the factory; if a $1.70 girder was "borrowed" from the pile today, put into a bridge, and "replaced" tomorrow in "kind" with a $4.00 girder, there is no profit as long as he keeps the $4.00 girder for emergency use. In the briefs, it is argued that the appellant is like a merchant, who constantly replenishes his stock, always striving to keep a stock on hand to meet the demands of his trade. That but begs the question. In the first place, inventories are "necessary" for the multitudinous transactions of merchants, who buy first and sell afterward; they are not necessary for those who keep no finished stock, who sell no goods, and who always contract first and buy afterward. Moreover, merchants keep no standby stock for years, promptly replacing in kind each item borrowed therefrom.

Taking the whole business of the taxpayer, as stipulated, and bearing in mind the admonition that the substance and not the form controls, we cannot escape the conclusion that, as a matter of fact, the existence or absence of this emergency supply doesn't add a dollar to the profit the taxpayer made on any contract he has ever executed; under the facts, it cannot affect his income, except as a good reputation helps him to other contracts, upon which he will pay a tax."

Conclusion.

We have endeavored to show that there was no income upon which to assess the tax. If we have succeeded, then the Inventory Statute and Regulations are of no consequence in the decision of the case, for the tax was assessed as a tax upon income and if there was no income it follows there can be no tax. The court below announced no rule of law in conflict with any decision of this court or of any other of the Courts of Appeals. It merely construed the *agreed* facts, necessarily limited to this case, and applied the settled law to such restricted facts. The Commissioner of Internal Revenue cannot be heard to say to a taxpayer "I agree you have had no income but, nevertheless, I will assess an income tax against you because you have not observed a departmental regulation, the sole purpose of which is to ascertain and determine whether or not you enjoyed an income, which, as stated, I agree you did not." In language made classical by the Supreme Court of Missouri, he cannot "blow hot and cold."

Hence, when the time and event shall arise that the taxpayer liquidates the emergency material, then and not until then may the Commissioner of Internal Revenue assess a tax upon the income derived from such liquidation, viz., the difference between its original cost in 1916 of $1.70 per hundredweight f. o. b. Pittsburgh, or $2.136 per hundredweight f. o. b. Kansas City, upon the one hand, and the higher liquidating price received therefor, upon the other, similarly in all respects, as he might do if such material had re-

mained untouched and unmolested, preserved in its original form (as it was in substance) freed from the practice of borrowing and replacement set forth in the stipulation of facts upon which the case was tried; and if the liquidating price should be lower than such original cost, then, under the same formula of fact and law, the taxpayer may have the advantage thereof as an offset to its then earnings, with the resultant diminution of its taxable income.

The judgment of the court below (reversing the judgment of the Board of Tax Appeals) should be affirmed.

Respectfully submitted,

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APPENDIX.

Atlantic Cost Realty Company v. *Commissioner of Internal Revenue*, 11 B. T. A. 416, 418.

"The taxpayer with its affiliated corporation, was engaged in buying and selling land for profit. When it filed its consolidated return for 1918 it claimed for the first time that its income should be determined by the use of a so-called inventory of its lands at market value, and upon that basis it reported net income of $14,204.39 and paid a tax of $1,464.53. * * *

We are of opinion that the petitioner has no such right as it claims, that it may not determine its income by revaluing its lands from year to year, and therefore that there is no occasion for findings of fact as to market value of the parcels in question at the close of 1918.

Income is not ordinarily determined by the fluctuations in value of property upward or downward during the continuation of the same ownership. Increment is not added to, nor is a drop in value deducted from, earnings until it has been realized by a sale, loss or other cognizable disposition of the property. Section 203 is a departure from this and it must be limited to its apparent intendment as disclosed in its terms and if necessary in its history. It provides:

> 'That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.'

It was first enacted in the Revenue Act of 1918 and has remained unchanged in each of the later Acts of 1921, 1924 and 1926. In the report on the proposed 1918 Act made by the House Committee on Ways and Means, the Committee said:

> 'In many cases the only way that the net income can be determined is through the proper use of inventories. This is largely true in the case of manufacturing and merchandise concerns. The bill authorizes the Commissioner to require inventories whenever in his opinion the same is necessary in order clearly to reflect the income of the taxpayer.'

The Senate inserted the words 'conforming as nearly as may be to the best accounting practice in the trade or business,' and thus the section was enacted.

This carefully guarded language may not be construed as creating in all taxpayers the right to determine income by the use of an inventory of property on hand. The use of inventories must be reasonably necessary to the determination of income. The basis of their use must be prescribed by the Commissioner, not arbitrarily, but in conformity to the best accounting practice in the trade or business and as most clearly reflecting income. The language indicates no intention to recognize in any trade a new method of determining income or a new limitation upon income, but only a recognition of the use of inventories in such trades or businesses, like 'manufacturing and merchandise concerns,' as had been found to require such accounting practice."

* * * * * * * *

"It seems plain that the use of inventories is not practical in such a business. * * * Instead of being a more convenient method of accounting, as it is with large stocks of small merchandise being frequently turned over, it is so cumbersome and uncertain as to be generally impractical."

SUPREME COURT OF THE UNITED STATES.

Nos. 323 and 324.—October Term, 1929.

Robert H. Lucas, Commissioner of Internal Revenue, Petitioner,
vs.
Kansas City Structural Steel Co.

On Certiorari to the Circuit Court of Appeals for the Eighth Circuit.

[April 14, 1930.]

Mr. Justice Brandeis delivered the opinion of the Court.

The Kansas City Structural Steel Company, a Missouri concern, appealed to the United States Board of Tax Appeals from determinations by the Commissioner of Internal Revenue which made an increase of $7,656.74 in the company's 1918 income tax and of $15,953.36 in its 1920 income tax.[1] These additions were due wholly to changes made by the Commissioner in the inventory valuation of material carried in stock. The Company valued at a constant price all the material which did not exceed in quantity what was said to be the normal stock on hand.[2] The Commissioner revalued this at current market prices. The changes resulted in increasing the December, 1918, inventory by $165,849.46 and the December 31, 1920, inventory by $117,113.61. The Board of Tax Appeals sustained the Commissioner's action. 11 B. T. A. 877. Its decision was reversed by the United States Circuit Court of Appeals for the Eighth Circuit. 33 F. (2d) 53. This Court granted writs of certiorari, 280 U. S. —.

Section 203 of the Revenue Act of 1918, Feb. 24, 1919, c. 18, 40 Stat. 1057, 1060, provides: "That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the

[1]Other matters were in dispute before the Commissioner and the Board, but these are the only disputed items carried to the Circuit Court of Appeals and presented for our decision. No. 323 involves the tax for 1918; No. 324, that for 1920. Except for the years and the amounts the facts in the two cases are identical.

[2]The system followed, if intended as a method of inventory, is known to accounting as the "base stock," "minimum" or "cushion" method.

approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."[3] Regulations 45 (1920 edition, as amended by Treasury Decision 3296) provides, in Article 1581, that "inventories at the beginning and end of each year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor." Article 1582 declares that the basis of valuation "most commonly used by business concerns and which meets the requirements of the revenue act is (*a*) cost or (*b*) cost or market, whichever is lower;" that "goods taken in the inventory which have been so intermingled that they cannot be identified with specific invoices will be deemed to be . . . the goods most recently purchased"; that the "taxpayer must satisfy the commissioner of the correctness of the prices adopted;" and that: "(*d*) Using a constant price or nominal value for a so-called normal quantity of materials or goods in stock" is not in accord with the regulations.[4]

The Company is engaged in the fabrication and erection of steel plates for buildings, bridges, tanks, etc. It does not carry finished products in stock, but fabricates the plates for specific structures or contracts. It orders material from the mills for each structure or contract; but it also keeps a supply on hand in order "to insure the prompt and orderly execution of contracts in view of delay, etc., incident to shipments from the mills and other exigencies affecting the availability for use when needed of material ordered for a particular job." Material is taken from this supply as and when needed; and the stock is subsequently replenished.[5] On December

[3]This provision was incorporated in every Revenue Act since 1918. 1921, c. 136, § 203, 42 Stat. 227, 231; 1924, c. 234, § 205, 43 Stat. 253, 260; 1926, c. 27, § 205, 44 Stat. 9, 16; 1928, c. 852, § 22 (c), 45 Stat. 791, 799. Although no similar provision was made in earlier acts, regulations of the Department supplied it. Internal Revenue Bureau, Regulations 31, arts. 2 (3) & (4); Regulations 33, art. 161; Regulations 33 (Revised), art. 91, 92, 120.

[4]The provision relative to the valuation of inventories at a constant price was, in effect, a restatement of a Treasury ruling promulgated in September, 1919, as Advisory Tax Board Ruling No. 65, T. B. R. 65, C. B. 1, 51.

[5]The stipulated facts recite: "When such material is used it is charged to the contract at its replacement cost and is promptly replaced with material of a like kind and in a like quantity." The phrase "charged to the contract" evidently means that it is so charged in those accounts on the Company's books which are designed to guide it in determining the cost of a particular job.

31, 1916, the quantity in stock was 5,554 tons. The Company then inventoried it at cost—$1.70 per hundredweight f. o. b. Pittsburgh. At the close of each year thereafter until 1921, the Company inventoried its stock on hand up to 5,554 tons at that price, regardless of its actual cost or the market, and the excess, if any, at cost or market price, whichever was lower. In the tax years in question, the market was much higher. It is not shown what the actual cost of the stock then on hand was, or that any of it had cost as little as $1.70.[6] The Commissioner therefore revalued the entire stock at market price, with the consequent increase in the taxes complained of.

First. Whether in a particular business inventories are necessary for the determination of income is a practical question left by the statute to the judgment of the Commissioner. On that question, he and the Company did not differ. In every year, it, without any question or protest, used inventories in making its return. The dispute was merely on the method of valuation to be adopted for that part of the stock which it calls its normal stock. Throughout, the Company valued at cost or market prices all stock in excess of 5,554 tons; and since 1921 has so valued all the stock on hand.

It is not contested that if inventories are necessary in order to determine the Company's income, the "base stock" method does not fulfill the desiderata. The Federal income tax system is based upon an annual accounting period. This requires that gains or losses be accounted for in the year in which they are realized. The purpose of the inventories is to assign to each period its profits and losses. In years of rising prices, the "base stock" method causes an understatement of income; for it disregards the gains actually realized through liquidation of low price stock on a high price market. In times of falling prices, it causes an overstatement of income; for it ignores the losses which result from the consumption of high price stock. This method may, like many reserves which business men set up on their books for their own purposes, serve to equalize the results of operations during a series of years. But it is inconsistent with the annual accounting required by Congress for

[6] In September, 1917, the Government fixed the price of structural shapes, f. o. b. Pittsburg at $3 per hundredweight and of tank plates at $3.25. After relinquishment of Government control, the prices fell. Those in 1920 were, for structural steel $2.45, for tank plates $2.65. In 1921 the prices fell to $1.50

income tax purposes. It results in offsetting an inventory gain of one year against an inventory loss of another, obscures the true gain or loss of the tax year and, thus, misrepresents the facts. It does not conform with the general or best accounting methods and is apparently obsolete.[7] The Company disclaims any defense of the base stock method; and the lower court disapproved it.

Second. It is urged, however, that the inventory requirement is not applicable to the Company's stock to the extent of 5,554 tons; that the Company is not a dealer, manufacturer or producer, but rather a contractor or builder; that its income results from the performance of its construction contracts; that the material in its stand-by stock has no relation to these contracts, the contract prices, or the Company's profits; that the material from this stock is only borrowed for specific jobs and is promptly replaced in kind; that it is not an income producing factor, but is like the Company's machinery and equipment; and that any accretion to the value of this material is of no consequence until a final liquidation. The contentions are inconsistent with the Company's practice and are unsound.

The Company's purchase and production of steel plates is obviously an income producing factor. Throughout the years, the Company has varying amounts of material on hand. The value of the particular material used, at the time of use, plainly affects its profits. That the material is replaced in kind and its amount kept within some limits is not exceptional and is of no significance. Most concerns strive ordinarily to carry no more stock than is required for the safe and profitable conduct of the business. They plan neither to run short nor to overstock. They replace supplies as they are consumed. And the cost or value of the new material is properly reflected in the later inventories and returns. There is nothing peculiar about the 5,554 tons,—except that that happened to be the amount of stock on hand on December 31, 1916. It is not a permanent stock, like machinery or equipment. Nor is it merely depleted

[7]In a well reasoned report, the Advisory Tax Board, in 1919, ruled that the "base stock" "minimum" or "cushion" method did not withstand "the changing tests of time" and could not be approved. Since then, all Regulations of the Department expressly prohibited its use. See Regulations 45, art. 1582; Regulations 62, art. 1582; Regulations 65, art. 1612; Regulations 69, art. 1612; Regulations 74, art. 102. No case has been found in which any business concern has challenged the correctness of these prohibitions and they have been approved by accountants. 1 Montgomery, Income Tax Procedure (1926 ed.) 712; Klein, Federal Income Taxation (1929), ¶ 14:13(d), p. 375.

by borrowing and promptly restored to that fixed size. On the contrary, the stock has fluctuated from about 3,000 tons in 1918 to 11,000 tons in 1920.[8] There is no stand-by stock set aside and earmarked as such. The material is all comingled and is indiscriminately used in production, as and when needed. No reason is given for excepting 5,554 tons—no more and no less. To draw an artificial line at that amount would distort the computation of income in the accounting periods, although the errors might be equalized in a series of years. Since inventories are properly deemed necessary, the exception of that or any amount is nothing but the use of the discarded "base stock" method.

The Company's case falls far short of meeting the heavy burden of proving that the Commissioner's action was plainly arbitrary. Compare *Lucas* v. *American Code Co.*, 280 U. S. 445, 449; *Williamsport Wire Rope Co.* v. *United States*, 277 U. S. 551, 559.

Reversed.

The CHIEF Justice did not take part in this case.

A true copy.

Test:

Clerk, Supreme Court, U. S.

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[8]The quantities on hand at the end of each of the several years were:

December 31, 1916	5,554 tons
December 31, 1917	5,298 tons
December 31, 1918	5,887 tons
December 31, 1919	6,957 tons
December 31, 1920	7,246 tons
December 31, 1921	4,512 tons
December 31, 1922	9,341 tons
December 31, 1923	8,732 tons
December 31, 1924	10,411 tons
December 31, 1925	7,202 tons
December 31, 1926	8,126 tons